Long-term investment and the Sustainable Company: a stakeholder perspective

Vol. III

Edited by Sigurt Vitols
Long-term investment and the Sustainable Company: 
a stakeholder perspective
Dedicated to the Memory of
Ieke van den Burg (1952-2014)

Photo: Liesbeth Sluiter
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European Trade Union Institute (ETUI)
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Introduction: a stakeholder perspective on the long-term investment debate

Sigurt Vitols

Since the onset of the Great Financial Crisis (GFC) in 2007/8 a widespread and intensive debate has emerged regarding the existence of a serious lack of long-term investment around the world. This debate is significant for a number of reasons. Most profoundly, it raises the question of whether or not there is a fundamental mismatch between the incentives and behaviour of financial investors and companies on the one hand and the needs of society on the other. A positive answer to this question implies the need for fundamental reform across a range of institutions which influence the way economic resources are saved, distributed and invested. Secondly, it addresses the issue of responsibility for the GFC. Although much has been already written and said on this, it is important to emphasise the structural causes of the crisis, above and beyond blaming greedy bankers, corrupt politicians and weak regulators. Although widespread individual malfeasance clearly played a crucial role, showing that there is a structural bias towards ‘short-term’ speculative trading over long-term investment would reinforce the argument for fundamental reform. Thirdly, it is an opportunity to pose the question of what the fundamental needs of our society and economy are, and in doing so supporting the emerging view that we must do much more to promote sustainability, including massively increasing long-term investment in environmentally- and socially-friendly products, processes and infrastructure. And finally, it is a chance to contrast the ‘stakeholder’ approach to economic organization and regulation with its main competitor, the neo-liberal paradigm.

The debate on whether or not there is a lack of long-term investment in our economies is not a new one, nor is institutional reform aimed at promoting it.¹ In particular the Anglo-Saxon ‘liberal’ market economies have experienced a number of waves of soul-searching about whether or not their financial institutions and companies are making sufficient improvements.

¹. On this see the contribution by Jackson and Petraki (2011) to the first Sustainable Company volume.
amounts of the kinds of investment needed to achieve economic competitiveness. For example, in the UK there has been a longstanding critical comparison of its own economy with countries like Germany and France whose industrial performance has not only ‘caught up’ but also overtaken. The financial institutions of the City of London have received a large share of the blame for an alleged neglect of long-term investment in British industry, a criticism shared by the Macmillan Committee set up by the British government to investigate the causes of the 1929 stock market crash and ensuing depression. This criticism led to the establishment of Industrial and Commercial Finance Corporation (ICFC) in 1945 by the Bank of England and the major British banks, which was supposed to provide long-term capital to companies, in particular to small and medium-sized companies lacking access to the stock market.²

In the US, the Great Depression led to a widespread belief that its market economy was characterised by a lack of demand and excessively speculative financial markets, a belief which underlay the creation of institutions such as the Federal National Mortgage Association (Fannie Mae) during the New Deal. The fear that the US economy would fall back into depression with the termination of the World War II-related demand stimulus as well as the feeling that ‘command’ economies like the Soviet Union did not have an investment problem led to the maintaining and in part expansion of these programs in the 1950s and 1960s (Freeman 2000). In the 1980s and 1990s a number of initiatives were established to investigate the causes of lagging industrial competitiveness relative to countries such as Germany and Japan. The most prominent of these was the Council on Competitiveness, a group of executives, academics and trade union officials which commissioned research by 25 academics. The research effort was led by the business school guru Michael Porter and summarised in the article ‘Capital Disadvantage: America’s Failing Capital Investment System’ (Porter 1992).

Thus although this debate is not new, what is different since the GFC is how widespread the debate has become and with what intensity it has been conducted, both on national and international levels. On the national level, the most widely noted of the numerous official efforts to investigate the causes of the financial crisis was the Kay Review of Equity Markets and Long-term Decision Making (for a detailed analysis of this

². The ICFC was subsequently renamed 3i (Investors in Industry) and floated on the stock market. It is currently one of the largest private equity groups in the world.
see the chapter by Williamson in this volume). This investigation has received widespread attention outside of the UK because of the quality of its analysis and policy recommendations. On the international level numerous publications by organizations such as the OECD have also looked at the problem of short-term (including speculative) tendencies in financial markets in conjunction with the issue of the need for long-term investments in environment, infrastructure, housing and education (see the chapter by Habbard in this volume). On the European level the problem of short-termism is also being intensively discussed, with the European Commission arguing that:

The economic and financial crisis has affected the ability of the financial sector to channel funds to the real economy, in particular to long-term investment... The ability of the financial system to channel funds to long-term investments will be essential in securing Europe’s position on a sustainable growth path (European Commission 2014:1).

Activities initiated by the Commission include consultations on the general problem of long-term financing of the European economy and on the need for a Capital Markets Union in Europe. In the area of corporate governance the main policy measure for promoting long-term investment advanced by the European Commission is the Proposed Directive revising the Shareholder Rights Directive (see the chapter by Johnston and Morrow in this volume for an analysis).

From a stakeholder point of view, while many of these official investigations have done a good job of identifying the root causes of short-termism, the policy recommendations and proposed measures have generally fallen short of what would be needed to fundamentally alter the behaviour of financial investors and companies. As Williamson points out, although the Kay Review provides an excellent analysis of underlying problems, the recommendations made for the most part are based on a voluntarist approach rather than advocating the passage of ‘hard law’ measures. Furthermore, policy recommendations focus on investors and companies, to the exclusion of stakeholders such as employees who could also play a significant role in promoting long-term investment.

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3. For documentation of these activities see the Commission website on long-term financing: http://ec.europa.eu/finance/general-policy/financing-growth/long-term/index_en.htm#maincontentSec5
Given that the presence of an adequate amount of long-term investors and investment is a key component of the Sustainable Company, the GOODCORP network of academic and trade union experts on corporate governance and company law decided to dedicate a third volume in the Sustainable Company book series to this specific topic. As discussed in the introduction to the first Sustainable Company volume (Vitols and Kluge 2011) and elaborated in the second book (Vitols and Heuschmid 2012), the GOODCORP network is dedicated to promoting a stakeholder approach to key issues in corporate governance and company law. Following the same methodology used for the first two volumes, members of the network working on this specific issue were invited to provide contributions to this volume; their proposals were discussed at meetings of the network. In a couple of cases new members working on the issue were invited to join the group and contribute.

Based on this work, as well as on some of the contributions to the previous volumes (in particular Jackson and Petraki 2011), a number of key principles for a stakeholder approach to the long-term investment debate have been developed:

1. **The promotion of long-term investment is more than a question of investment time horizons, as sustainability is also crucial.** Although this point may seem obvious to some, it is important to emphasise this since it is necessary to do more than encourage a lengthening of the duration of investments. For example, one official definition of ‘long-term investment’ is investments with maturities of at least five years (by the Financial Stability Board) (FSB 2013: 2). From a stakeholder perspective, holding the shares of a company which does not respect basic labour and human rights for over five years would be viewed quite critically. Thus although short-term investments by their nature are generally ‘speculative’, the long-term investment debate needs to focus as much on the types of investments made and whether or not they fulfil societal needs as on the issue of time horizons itself.

2. **As there is no ‘silver bullet’ which will encourage long-term investment, a package of policy measures is needed.** The official inquiries have for the most part identified multiple causes for ‘short-termism’, so almost by definition they must prescribe a set of measures rather than a single solution. One of the most wide-reaching academic analysis of the problem to date (Jackson
and Petraki 2011) is quite sobering insofar as it identifies short-termism as a deeply-embedded set of mutually-reinforcing behaviours and expectations on the part of a multiplicity of actors – not only on the part of investors and companies, but also of ‘gatekeepers’ such as auditing firms and rating agencies. This analysis suggests that the incentives and behaviour of all key actors must be changed to break out of the trap of short-termism. Having said this, financial transactions taxes (FTT) would arguably be the single most effective measure to deter much speculative short-term behaviour by financial investors with a ‘trading’ mentality (see the chapter by Botsch in this volume on this issue).

3. **Stakeholders should be empowered to help promote long-term sustainable investment.** The official inquiries at the most pay lip service to the involvement of actors other than investors, companies and regulators. However, stakeholders generally have a greater interest in promoting the long-term sustainability of companies than investors and managers. In particular workers have a stake in the future of the company they work for and in the sustainability of their working conditions and of the products and services they produce. Through their daily activities they are also uniquely qualified to identify problems and possible solutions within the production process and organization. Companies with stronger worker involvement on average are more sustainable than those without worker participation (ETUI/ETUC 2014: 110). Thus a key measure to promoting long-term sustainable investment is the strengthening of worker involvement in the company (see Kowalsky chapter in this volume), for example through board level employee representation and European Works Councils. These workers also need to be properly informed and consulted on sustainability issues (see the chapter by Cremers here). NGOs can also play a key role, for example in monitoring company performance and compliance with environmental standards, supply chain organization, etc.

4. **Policy measures need to address more than publicly-traded equity investments.** At the European level in particular much of the discussion is focused on publicly-traded companies and their securities. This is in part because internationalised stock markets more clearly fall under the European Commission’s authorization to propose regulatory measures for issues that have a
strong cross-border dimension. However, privately-owned (for the most part small and medium-sized) companies account for the bulk of employment and economic activity, and thus also should be addressed by policy measures. Furthermore, much cross-border investment is accounted for by intra-firm investment in subsidiaries, joint ventures, etc. in other countries (see Mückenberger chapter in this book). The debate on and policy measures for long-term sustainable investment thus also need to cover non-listed and intra-firm investments.

5. **Pension funds can play a leading role in promoting long-term sustainable investment.** It is one of the strongest indicators of the failures of our current system that many pension funds, which in principle administer one of the most long-term sources of capital (workers’ retirement savings), invest a large proportion of their funds in a short-term manner. Most pension funds delegate the management their funds to investment intermediaries which typically have a high ‘churn rate’ (i.e. they buy and sell their securities frequently) and invest in short-term oriented investors such as many classes of hedge funds. The fact that pension funds own a significant proportion of equity capital and have worker representatives on their boards mean that they have a particularly large potential for long-term sustainable investment. The role that pension funds could play are discussed in particular in the chapters by Klec and Mum, Habbard and van den Burg in this volume.

The GOODCORP group has thus outlined an ambitious agenda for the promotion of long-term sustainable investment which goes far beyond what is currently proposed by the European Commission, the OECD and other international organizations. As discussed in the concluding chapter to this volume, this type of investment is one of the key components of the Sustainable Company. This agenda thus complements many of the other policy measures that have been proposed in the previous two volumes in this series, such as worker participation and sustainability/non-financial reporting by companies.

The following briefly summarises the individual contributions to this volume. In Chapter 1 Andrew Johnston and Paige Morrow analyse the justification for and features of the Proposed EU Directive on Shareholder Rights, which has been the major policy proposal by the European Commission aimed at addressing short-termism in European financial
markets. Although the Proposed Directive does contain some positive features, for the most part it takes a rather narrow approach to the issue. Johnston and Morrow thus argue that a much broader agenda ‘beyond shareholder empowerment’ is needed to promote long-term sustainable investment. In the next chapter Janet Williamson provides a detailed analysis of the influential UK-based Kay Review of Equity Markets and Long-term Decision Making as well as the British Trades Union Congress’ response to this. Williamson is for the most part supportive of the Review’s analysis of the problems with the short-term orientation of British companies and investors. However, the policy recommendations coming out of the Review are based too much on a voluntarist approach and fall short of trade union demands for binding regulation. Although the UK is arguably the most extreme case of short-termism in the world today, the Review has clear relevance outside of the UK because of the similarity of structural problems in many other countries. Chapter 3 by Andreas Botsch reviews the rationale for and current state of play of proposals for financial transaction taxes (FTT) at the European level. Although FTT would only add up to a very small fraction of the total transaction value, they could have a major impact in discouraging short-term trading strategies by reducing the profits that can be derived from such speculative investment approaches. As such, it could be a very effective measure in extending the time horizons of financial investors.

The next two chapters focus on the potential role of pension funds in promoting long-term sustainable investment. Pierre Habbard in Chapter 4 identifies the ‘lengthening of the investment chain’ as one of the primary causes of short-termism in the financial system, as the final investors are frequently a number of steps removed from the ultimate owner, the workers. This problem must be addressed if workers are to exercise effective voice in corporate governance. Finally, the great potential for investment in environmentally-friendly infrastructure and technologies is discussed. In the next chapter, Klec and Mum review the literature on the potential for strengthening worker voice through pension fund activism as well as the current state of trade union activism through pension funds throughout the world. In their conclusion they draw up a balanced picture of the current problems with as well as the future potential for closing the gap between factual ownership and actual control of workers’ capital.

The following three chapters address topics which are outside the scope of the narrow debate on short-termism, but which can be seen as key
areas for action in terms of a broader stakeholder approach to long-term sustainable investment. Jan Cremers in Chapter 6 summarises the results of a study done by the ETUI’s SEEurope Network on the state of worker involvement in sustainability reporting throughout Europe. Strong rights to information on aspects of sustainability such as workplace conditions and environmental performance are needed so that workers can be an ‘adequately informed’ stakeholder. Although there are some interesting national, sectoral and company-based examples of strong information rights and practices, generally worker rights in Europe fall short of what would be needed for adequate information. In Chapter 7 Ulrich Mückenberger addresses the issue of the potential of international investment agreements (IIA’s) to promote long-term sustainable investment. Although previous IIA’s have focused on the rights of investors in ‘host’ countries, a newer trend is the inclusion of social and environmental obligations on these investors. Through new competencies defined through the Treaty on the Functioning of the European Union, the EU has an increased potential for encouraging sustainable investment through negotiating IIA’s with strong sustainability requirements with other countries. In the following chapter Wolfgang Kowalsky outlines the current tools available for employee involvement in supporting Sustainable Companies. Although some tools are available, such as European Works Councils and board level employee representation in SEs (European Companies), the current state of legislation in the EU is not adequate for supporting the level of worker involvement needed. The ETUC has thus taken a historic step forward in demanding board level employee representation in European companies and is formulating further demands for minimum standards for employee involvement.

Chapter 9 is based on a presentation made by Ieke van den Burg at the 2011 meeting of the Transatlantic Social Dialogue, which is organised annually by the European Trade Union Institute, the Worker Institute at Cornell University and the Hans Böckler Foundation. In this presentation she outlined what she called her ‘ten plus one commandments’ for action regarding the nexus between pension funds, corporate governance and social responsibility. These commandments were based on her many years of experience as a trade unionist, member of the European Parliament, member of company boards and a pension fund board of trustees as well as other initiatives. They provide an excellent summary of the challenges as well as the need for specific actions to more effectively exercise worker voice in corporate governance. The final chapter summarises the results to date of the Sustainable Company project as
well as the ‘road ahead’ in terms of further activities to realise the Sustainable Company.

Here I would like to acknowledge a number of persons and organizations for their help in realizing the publication of this volume. Firstly I would like to thank the members of the GOODCORP network for their contributions to this book. Furthermore, I am grateful to the ETUI’s European Workers’ Participation Competence Centre (EWPCC) and to the board level employee representatives who contribute to the EWPCC for providing funding for GOODCORP meetings and for this volume. Lut Coremans provided tireless administrative support for organizing network meetings and monitoring the budget. Géraldine Hofmann competently guided this book through the publication phase under extremely tight deadlines.

Finally I would like to acknowledge the inspiration and support of Ieke van den Burg, who died on 28 September 2014. Ieke was a very special person who had the rare ability not only to grasp the complex connections between trade unionism, worker participation, corporate governance and finance, but also to effectively act on this knowledge. In addition to her numerous other activities after her time as an MEP between 1999-2009, including a prime role in the establishment of Finance Watch, she was an active member of the GOODCORP network and hosted a meeting in November 2010 in Amsterdam. At the 2011 meeting of the Transatlantic Social Dialogue, which we both attended, she said she would like to write up her presentation for this, the third volume in the Sustainable Company series. It is to her memory and inspiration that the GOODCORP group would like to dedicate this volume.

References

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Chapter 1
Towards long-termism in corporate governance: the Shareholder Rights Directive and beyond

Andrew Johnston and Paige Morrow

1. Introduction

This chapter analyses the European Commission’s 2014 proposal to amend the 2007 Shareholder Rights Directive. This proposal (‘the Proposed Directive’) is significant because it is the Commission’s main initiative to promote long-term investment through corporate governance. While the Proposed Directive in some ways represents a step forward relative to the 2007 Directive, nevertheless its provisions fall some way short of what would be necessary to substantially promote long-term sustainable investment and the Sustainable Company.

In the Proposed Directive, the Commission has set itself the ‘overarching objective’ of ‘contribute[ing] to the long-term sustainability of EU companies’ (COM(2014) 213: 2). The debate about the causes of and solutions to short-termism in corporate governance is a long-running one. However, short-termism is difficult to define, let alone counteract through law. In his 2012 report, John Kay defined short-termism as ‘myopic behaviour’ and ‘the natural human tendency to make decisions in search of immediate gratification at the expense of future returns’ (Kay 2012: 14). According to Kay, short-termism is manifested in the UK in the ongoing decline in levels of business investment; hyperactivity in mergers and acquisitions markets as decision-making is increasingly

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1. This chapter draws on our ‘Commentary on the Shareholder Rights Directive’ prepared for the conference, ‘Shareholders’ Rights: The Key to Ending Short-termism in EU Companies?’ held at the European Parliament on 10th December 2014. The commentary is available at: http://ssrn.com/abstract=2535274. In preparing that commentary, we received significant assistance from Dr Tristan Auvray (Maître de conférences en économie, Université Paris XIII), Dr Thomas Dallery (Maître de conférences en finance, Université du Littoral Côte d’Opale), Professor Blanche Segrestin (Professor in the Centre de Gestion Scientifique, Mines ParisTech) and Professor Beate Sjäfjell (Professor in the Department of Law, University of Oslo and Head of the Sustainable Companies Project). We also acknowledge helpful comments throughout the process from Filip Gregor, Tamara Hervey, Mark Brown, Oisin Suttle, Kaylee Zournas, Andreas Ruhmkorf and Robert Burrell.
influenced by financial market considerations; and the enormous damage
to the reputation and future prospects of blue-chip companies such as
BP, Royal Bank of Scotland and Halifax Bank of Scotland (see also
chapter by Williamson in this volume).  

Short-termism arises because listed companies find themselves subject
to relentless capital market pressure to maximise immediate returns to
shareholders. A number of mechanisms work together to create this
pressure. If investors in a company sell their shares in significant
numbers, or if a company fails to meet analysts’ quarterly earnings
expectations, its share price will decline precipitously (see Millon 2002).
In countries which have implemented the European Takeover Directive
to the letter, this will open up the threat of hostile takeover. Executives
respond to this potential threat by engaging in dialogue with shareholders
and trying to persuade them not to sell their shares. Executives hear and
frequently accede to the demands of short-term investors for financial
engineering in the form of asset sales and increasing leverage, and then
distribute ‘surplus’ cash to the shareholders through dividends and,
especially, share buybacks. The chains of intermediaries between
companies and their ultimate shareholders accentuate this pressure for
immediate returns, as many asset and investment managers are given
incentives and have their performance assessed in ways which are not
well aligned with the long-term interests of institutional shareholders
such as insurance companies and pension funds (Myners Report 2001).
Finally, and most importantly from the perspective of this chapter, the
current practice of executive pay strongly incentivises executives to focus
on short-term share price. Hence, executive remuneration reinforces,
rather than works against, this capital market pressure for maximisation
of returns to shareholders in the short term.

Short-termism has very serious adverse effects on companies, their
shareholders and their stakeholders, and undermines the macroeconomy.
Companies which increase leverage and sell off assets are certainly able
to offer enhanced returns to shareholders in the short term, but these
kinds of financial restructuring make companies riskier and more
vulnerable to cyclical downturns over the longer term, as their room for
manoeuvre is reduced. Companies which commit large amounts of their

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2. In its position paper on the Proposed Directive, Eumedion (2014), the Dutch forum on
corporate governance and sustainability for institutional investors, defined short-termism as
‘the overvaluing of short-term effects and the undervaluing of events in the long term’.
cash flow to share buybacks have less money available for investment in R&D (see for example Lazonick 2007), which reduces the long-term profitability of the company in question and harms the innovative capacity of the economy. Brossard *et al.* (2013) examined a sample of European companies and found that “institutional investors seem to promote R&D investment, whereas “impatient” investors seem to hinder it.” Where impatient investors hold large blocks of shares, this undermines R&D expenditure, presumably because they are able to put pressure on executives to distribute cash flow. Capital markets also create pressure to cut costs, which leads to environmentally harmful activities, including longer supply chains, products with a shorter life span and wholesale offshoring of jobs. Offshoring reduces employee trust and commitment to companies, leading to lower productivity, a declining skills base and ultimately lower macroeconomic demand in the EU economy.

The question, then, is how this problem should be tackled. Despite the range of interests and groups affected; the enormous social costs of short-termism as manifested for example in the Enron debacle and the global financial crisis; the conclusion of the de Larosière Group that shareholders pushed for more, not less, risk-taking before the global financial crisis; and the fact that in an era of zero interest rate policy, the ‘substantial current obligations’ of pension funds means that there can be no guarantee that even these institutional investors will have the long-term perspective expected of them (Millon 2013: 930), all policy proposals put forward to date have relied on shareholders to the exclusion of other stakeholders. In the UK, in pursuit of longer-term capital markets, and in the hope that shareholders might engage rather than exit, shareholders were: encouraged through soft law to engage or exercise stewardship since 2002; given an advisory vote on the remuneration report in 2002 and a binding vote on pay policy in 2013; and assisted with this by a variety of qualitative reports since 2006. All of this was explicitly intended to relieve short-term capital market pressures on corporate executives, yet the UK was one of the epicentres of the global financial crisis, and short-termism one of its key causes. Despite this, it is proposed to roll out this raft of measures – which have to date been distinguished only by their lack of success – across the whole EU. At the same time, the argument that other stakeholders could bring a longer-term perspective, and so act as a counterweight to capital market pressure, has gained little or no traction to date. In our view, this is a clear sign that the shareholder primacy paradigm of corporate governance has not only survived the financial crisis, it has actually tightened its grip on policy-makers.
This, then, is the context in which the Commission is proposing to amend the Shareholder Rights Directive. This chapter begins by exploring the Commission’s policy on shareholder engagement and long-termism. It then moves on to examine and critique a number of provisions contained in the proposal for an amended Shareholder Rights Directive. Finally, a number of wider changes to corporate governance are suggested. We consider that these would complement the Proposed Directive and steer company decision-making towards prioritising the long-term interests of the company, whilst respecting the interests of shareholders and other stakeholders.

2. The Commission’s policy on shareholder engagement and long-termism

In its 2012 Action Plan (Commission 2012), the Commission accepted the OECD’s approach that ‘Corporate governance defines relationships between a company’s management, its board, its shareholders and its other stakeholders.’ It emphasised that corporate governance is ‘first and foremost the responsibility of the company concerned’, with shareholders playing a ‘crucial role’ in its improvement, and so acting ‘in both the interest of the company and their own interest’. It then went on to note a ‘perceived lack of shareholder interest in holding management accountable’ and that ‘many shareholders appear to hold their shares for only a short period of time’. Despite the failure of shareholders to play the role expected of them in the past, the Commission announced its intention to ‘encourage’ shareholders ‘to engage more in corporate governance’, including giving them ‘more possibilities to oversee remuneration policy’. In the same publication, the Commission also accepted that the corporate governance framework exists ‘for employees’ as well as for shareholders, and that its effective operation ‘depends inter alia on checks and balances between the different organs and different stakeholders’ (a formulation repeated in the Preamble to the Proposed Directive). Going further, it recognised that poor remuneration policies and structures ‘lead to unjustified transfers of value from companies, their shareholders and other stakeholders to executives.’

Yet despite recognising that wider interests are at stake in corporate governance, the Commission confined its proposals almost entirely to shareholders, concluding that they ‘should be encouraged to engage more’ and that ‘shareholders should be able to express their views’ on
remuneration policies and practices. The only measure proposed to correct harm to the employees’ stake in remuneration decisions was the announcement of an investigation into the barriers to employee share ownership schemes. A detailed report has now been published (see Inter-University Centre 2014), and whilst more employee share ownership may well be desirable in terms of generating commitment, and counteracting short-term pressures and managerial opportunism (Inter-University Centre 2014:17), the Commission’s exclusive focus on employee financial participation obviously forecloses discussion about employee participation in corporate governance in their capacity as employees. Such participation could also lead to the articulation of the sought-after long-term perspective in corporate governance. Financial participation is not a substitute for employee participation in their capacity as employees.

However, this narrow approach to the question of scope is not surprising to long-standing observers of EU corporate governance. Those chosen to advise the Commission often adopt a reflexively shareholder-centric approach (see e.g. Commission 2002), and there is a copious literature arguing that its diffusion around the world proves that this approach is more efficient (see e.g. Hansmann and Kraakman 2001). Perhaps as a result, the Commission’s proposals in this area have frequently been influenced by the UK’s approach, which is the most shareholder-centric in the EU (although it has often been forced to compromise because of the variety of approaches taken by the different Member States). The Commission’s shareholder-centric orientation can be seen in the various proposals and justifications advanced by the Commission for the Takeover Directive, which firmly rejected giving employees any rights which might prevent a takeover occurring, as well as in the Commission’s increasing reliance on non-binding ‘soft law’ measures, which encourage the Member States to follow ‘best practice’ in matters of corporate governance (Johnston 2009).

Corporate governance debate in the UK is dominated by the shareholder primacy model. Company law leaves the interests of other stakeholders, as well as the time horizons used in decision-making, to directors and managers under a legislative regime of enlightened shareholder value. That regime allows directors to take account of a wide range of interests in running the company for the benefit of its shareholders. Underlying this approach is the belief that the various markets in which the company operates (labour, products, finance) will force managers to take sufficient account of interests of groups other than shareholders. It follows from this
that no intervention can be justified to give rights to stakeholder groups other than shareholders. There is some (albeit insufficient) recognition that the UK’s corporate governance system creates powerful pressures for managers to prioritise short-term returns to shareholders, but efforts to solve this complex market and organisational failure have focused exclusively on informing and empowering institutional shareholders. That narrow focus rests on the belief that these shareholders want managers to adopt a longer-term approach, and will articulate that perspective in their dealings with the company and its management, thereby solving the problem. Since 2001, the UK has tried varying combinations of soft law and information disclosure to get companies, capital markets and institutional shareholders to take a longer term approach to questions of corporate governance. No one could accuse the UK of being successful in this regard. Yet, each time a corporate governance disaster confronts them with the evidence that this approach does not work, UK policy-makers simply assert that there are further obstacles to be removed before shareholders can bring about the utopia of long-termism.

The Kay Review (2012) is a perfect example of this. John Kay diagnoses in extraordinary detail and perfect prose the various dysfunctions which characterise the UK capital markets and create a systemic tendency towards short-termism. Reviewing the various crises caused by the UK’s corporate governance system, Kay notes that ‘Many of the bad decisions described were supported or even encouraged by a majority of the company’s shareholders’ and that executive pay practices have only made matters worse, as the ‘attempt to create identity of interests between agents and principals has in practice become a principal source of friction between them’ (Kay 2012:20 and 45). These manifold and very costly failures might suggest that the existing corporate governance paradigm has failed, and that it is time for a new one. Yet when it comes to making recommendations, Kay limits himself to tweaking the corporate governance regime, recommending, for example, that executives should be paid bonuses in the form of shares and required to hold them ‘significantly beyond the executive’s tenure with the company’; that obstacles to asset manager engagement should be removed through the adoption of good practice statements; and that the ‘quality of engagement by investors with companies’ should be improved through the establishment of an investors’ forum.

There seem to be two complementary forces at work here. The first is the reluctance to question the axiomatic truth that furthering the shareholder
interest automatically equates to furthering the public good, and so leads to an optimal level of protection of stakeholder interests. The subject of that axiom has had to be qualified in more recent years as the ‘long-term shareholder interest’, because there is undeniable and extensive evidence that in the short term both the public good and the interests of various stakeholders have been greatly harmed by actions carried out in the name of the pursuit of shareholder value. The second is the belief, drawn from economic theory, that an optimal contract can be identified which will align executive self-interest with the long-term interests of the shareholders, and therefore the company, its stakeholders and society at large (Johnston 2014: 22). It matters little that that contract has not yet been found, nor that the costs of the search have been enormous to date. A few more tweaks to the law, and a little more encouragement of those passive institutional investors, and the optimal contract will simply emerge.

At the level of EU policy-making, the shareholder value consensus was temporarily shaken in the immediate aftermath of the financial crisis. The de Larosière report concluded that ‘shareholders’ pressure on management to deliver higher share prices and dividends for investors meant that exceeding expected quarterly earnings became the benchmark for many companies’ performance’ (de Larosière 2009: 10). Indeed, in its 2010 Green Paper on corporate governance in financial institutions and remuneration policies, the Commission stated that ‘confidence in the model of the shareholder-owner who contributes to the company’s long-term viability has been severely shaken, to say the least.’ (Commission 2010: 8). The Commission too noted that ‘new categories’ of shareholders were either passive or possibly ‘responsible for encouraging excessive risk-taking in view of their relatively short, or even very short (quarterly or half-yearly) investment horizons.’ In this context, the tools for alignment of directors’ interests with those of shareholders had actually ‘amplified risk-taking’ and contributed to ‘excessive remuneration’ (Commission 2010: 8). The Commission recognised that this mixture of passivity and aggressive demand for short-term returns ‘does not only affect financial institutions’, and promised to ‘launch a broader review covering listed companies in general.’ The Green Paper went on to identify a number of potential reforms, including a possible prohibition on the award of stock options and golden parachutes to the directors of listed companies, the reinforcement of civil and criminal liabilities of directors, and the elimination of shareholder control of financial institutions.
The following year, the Commission further committed to ‘[i]nitiat[ing] an open debate with citizens, enterprises and other stakeholders on the role and potential of business in the 21st century, with the aim of encouraging common understanding and expectations’ (Commission 2011: 4.2). To date, this has not been done. Indeed even in 2011, the Commission was distancing itself from the view that shareholders might be pushing for excessive risk-taking across listed companies as a whole. Instead, it claimed, this opportunistic behaviour in relation to financial institutions and their stakeholders ‘may be a special case because their operations are complex and difficult to understand’ (Commission 2011: 11). This rather unconvincing argument allowed the Commission to follow the UK’s approach and confine itself to the problem of shareholder passivity. By 2012, any doubts about the long-term contribution of the ‘shareholder-owner’ had disappeared, with the Action Plan of that year proclaiming that shareholders have ‘a crucial role to play in promoting the better governance of companies’ (Commission 2012: 3).

This chapter does not argue that shareholders should play no role in corporate governance. Rather, it argues that the UK’s current approach, which is largely embodied in the Proposed Directive is unlikely to succeed on its own; carries with it a risk of exacerbating the problem of short-termism; and closes off other promising avenues to re-orienting corporate decision-making toward the long-term. In particular, it fails to accord any role to employees, despite the fact that their interests in the company are long-term and illiquid.

Throughout this chapter, we canvass various ways in which employees might exercise some oversight or influence over executive pay, and matters of concern to them across corporate governance more generally. At the end of the chapter, we make some suggestions for wider reforms to corporate governance in pursuit of longer-term decision-making.

3. Analysis and critique of the Proposed Directive

3.1 The original Shareholder Rights Directive

The 2002 Report of the High-Level Group of Company Law Experts appointed by the Commission (High Level Group 2002) recommended harmonisation of the rights of shareholders in listed companies ‘to participate in the information, communication and decision-making
processes’. The Commission then proposed a strengthening of share-
holder rights in its 2003 Action Plan (Commission 2003: 2.3 and 3.12),
which led to the proposal and adoption of the Shareholder Rights
Directive.\(^3\) It came into force in 2007 with the aim of: facilitating the
cross-border exercise of shareholders’ voting rights through informa-
tion provision; reducing barriers to exercise of voting rights; encouraging
electronic voting; and guaranteeing the right to appoint a proxy. It also
encouraged formal activism by shareholders by requiring that share-
holders holding at least 5 percent of shares should be permitted to put
items on the agenda of the general meeting and table resolutions (Art 6),
and by requiring that all shareholders should have a right to ask questions
(Art 9). Whilst these formal rights to activism were generally already
recognised ‘across the major European jurisdictions’, changes were
required across a number of jurisdictions to create a floor of minimum
standards across the EU (for details see Scalera 2010). It is not clear
whether the introduction of the original Shareholder Rights Directive
contributed to the pressure, identified by the de Larosière Report and the
Commission, from shareholders for excessive risk-taking and increased
short-term returns. It seems more likely that that pressure was exercised
informally and through sell-side pressures, although, to the authors’
knowledge, there has been no detailed research on this point.

3.2 The Proposed Directive

The Proposed Directive goes much further than the original directive.
Where the original directive harmonised shareholder rights which
generally already existed across the Member States, the Proposed
Directive will give shareholders new rights – in most Member States – in
relation to directors’ pay. The mainstream debate on corporate
governance assumes that, in order to reduce agency costs, management
incentives should be aligned with the long-term interests of companies,
and therefore ultimately, their committed shareholders. This is commonly
done by using a variety of mechanisms to link management returns to
increases in the share price. Within the mainstream debate it is
recognised that incentives have failed to achieve the necessary alignment
with long-term shareholder interests, and there is much discussion of how
alignment might be improved. More critical approaches to corporate

\(^3\) Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies
(OJ L 184/17, 14.7.2007).
governance emphasise that from Enron to the financial crisis, poorly aligned incentives have led to corporate failure and enormous social cost. Even adherents of the principal/agent model recognise that executive remuneration may itself amount to an agency cost, since in practice pay levels are not set by shareholders but rather by the board of directors, which is expected to align the incentives of management and shareholders but may instead choose to award pay that exceeds what would be ‘optimal’ for shareholders (Bebchuk et al. 2002; Bebchuk and Fried 2004).

The correct alignment sought by agency theorists has certainly not been found to date; might never be found; and certainly will never be found on the basis of shareholder input alone. Since the long-term interests of companies also encompass the interests of the company’s stakeholders, input should be sought from those groups on questions relating to management incentives. We make some suggestions about this in the final section of this chapter.

More immediately, we offer evidence that, wherever shareholders have been given an advisory or a binding vote on executive pay, they have very seldom used it to vote against remuneration policies or reports. As such, it is hard to see how rolling out a binding vote on pay across the whole of the EU will lead to remuneration policies that better align executive incentives with outcomes that will benefit companies, their shareholders, employees and wider society.

Whilst we consider ‘say on pay’ to be the most important provision, the Proposed Directive also includes provisions aimed at further facilitating exercise of shareholder rights, and, more interestingly, provisions apparently intended to increase pressure on institutional investors and asset managers to engage with the companies in which they hold shares. In the remainder of this section we explore and critique the main elements of the proposal. We do not comment on the provisions relating to proxy advisors, or the provisions dealing with related party transactions, as we do not consider them to be a major driver of short-termism.

3.2.1 Identification of shareholders
Articles 3a & 3b of the Proposed Directive will allow companies to demand that intermediaries such as asset managers identify the institutional shareholders they represent. The aim here is to enable companies to communicate directly with their shareholders, and to promote participation and voting in meetings, either directly or through
intermediaries. This appears to be linked to a belief that shareholders will take a longer-term view of their investments than intermediaries, who often have strong incentives to produce impressive short-term results, which encourages lower-cost share sales rather than higher-cost engagement. However, given the immediate pressures on many institutional investors, there is no reason, absent unacceptable short-term performance, to expect investors that have delegated investment decisions to asset managers to then incur the costs of engaging directly with companies.

These improved communication channels could, however, be used to provide shareholders with the views of various stakeholders about the orientation of corporate governance. In particular, it would be desirable for the Proposed Directive to encourage companies to use this new communication channel to disseminate the views of stakeholders, and employees in particular, on corporate governance matters to shareholders. This would give shareholders access to a longer-term perspective and might inform and enhance the quality of their decision-making on matters such as ‘say on pay’.

3.2.2 Improving institutional investor engagement

Article 3f of the Proposed Directive will require institutional investors, on a ‘comply or explain basis’, to develop a policy on shareholder engagement, which must cover monitoring, dialogue, voting, use of proxy services and cooperation with other shareholders. Where the institutional investor uses an asset manager, it should publicly disclose key elements of its contract with the asset manager, including incentives and performance evaluation. The proposal aims to ensure that institutional investors engage with investee companies, either directly or through asset managers, in such a way as to influence their long-term performance. The underlying belief is that increasing the engagement of institutional investors and asset managers will reduce sell-side pressures, so reducing harmful short-term pressure on listed companies, which results in companies investing less in research and development and reducing employment in order to cut costs. This is expected to yield higher returns for end-beneficiaries in the long-term as longer-term investments in innovation and firm-specific human capital produce payoffs for shareholders.

While the objective is laudable, it is unclear that increasing transparency will lead to increased engagement. It seems unlikely that the end
beneficiaries of pension funds, for example, will impose meaningful pressure on their funds to take a longer term approach. It is also far from clear that, to the extent that it occurs, engagement will necessarily push companies to have a more long-term horizon.

The ‘institutional investor’ label says little about the extent of participation or the quality of shareholder engagement. There are important differences between pension funds, insurance companies, hedge funds and other investment funds, and even within each of those categories. The degree of engagement is determined by the institutional investor’s ‘business model’. When engagement is not a central part of the investor’s business model, public policies and voluntary standards seeking to improve the quality of engagement are likely to have limited effect (OECD 2014). The OECD (2009) has noted the rise of momentum investing by institutional investors, and the growing trend of institutional investors to invest in alternative investment funds (including hedge funds, private equity, and real estate funds), which are often opaque in terms of their strategy. Likewise there has been a marked decrease in the holding periods of institutional investors between 1991 and 2009 (De la Croce et al. 2011), and increased portfolio turnover by shareholders has been shown to have a negative impact on research and development expenditure by European companies (Brossard et al. 2013). These changing investment strategies, at least in part, reflect a broader chase for short-term yield at a time when interest rates in many economies have been at or close to zero for several years. They certainly do not inspire confidence that requiring the production and disclosure of an engagement policy will be sufficient to reverse this trend and encourage greater engagement on the part of shareholders.

Indeed, in the UK, an engagement policy has been a soft law requirement since the introduction of the 2002 Institutional Shareholders’ Committee (ISC) Principles. The requirement was endorsed by reference in the UK Corporate Governance Code in 2003, and has been a ‘comply or explain’ obligation since the introduction of the 2009 ISC Code, which became the Stewardship Code in 2010 following a recommendation of the Walker Report (2009). Yet there is no evidence from more than a decade of experience that these instruments have encouraged investors to call for a longer-term approach to corporate governance.

Reforms aimed at stimulating shareholder engagement need to go far beyond mere disclosure. In theory, institutional investors with long-term
liabilities should purchase and hold shares for the long-term, free from short-term pressures. In practice, they do not do this. One solution would be to encourage these institutional investors to hold their shares for much longer periods. Voting rights might increase (either by law or by default contractual provision) for long-term shareholders, or decrease each time shares are transferred. Alternatively, changes to accounting regulation and prudential norms might be used to encourage institutional investors to hold shares for periods that match their liabilities (Auvray et al. 2015).

3.2.3 Improving asset manager engagement
Article 3g will require institutional investors to disclose how their equity investment strategy aligns with the profile and duration of liabilities. This will involve disclosure of attempts to align manager incentives with institutional investor liabilities, as well as incentives for asset managers to make decisions based on ‘medium to long-term company performance’, and other factors, on a comply or explain basis. It is questionable whether end beneficiaries will actually use this information to create pressure for a longer-term perspective, but the provision of this information to the public will not be unduly costly, and could be useful for NGOs and other civil society organisations.

3.2.4 Shareholders’ ‘say on pay’
In the EU, Member States have until now generally required listed companies to allocate decision-making on pay to a remuneration committee on a ‘comply or explain’ basis (see Commission 2007: 8). However, shareholders are increasingly being given voting rights in relation to pay. Since 2002, the UK has given shareholders an advisory vote on the backwards-looking remuneration report, but studies suggest that few shareholders vote against these reports. While there have been examples of companies reviewing their entire pay schemes following shareholder votes, research suggests that ‘most remuneration reports in the FTSE 350 receive backing from around 90 percent of shareholders’. In FTSE 100 companies, around 3 percent of shareholders dissented in 2008, but levels of dissent have been considerably higher since the financial crisis, and in 2009, around one fifth of FTSE 100 companies had more than 20 percent of their shareholders dissent (BIS March 2012 at 14). These levels of dissent are higher than for other corporate resolutions, but do not suggest significant shareholder concern with levels or structures of executive pay. In a few cases, dissent has been much higher, but companies have not responded to shareholder concerns (for more details see BIS May 2012: 10-12).
Similarly, in the US, it has been mandatory since 2010 to hold a shareholder advisory vote on executive compensation at least every three years (§951 Dodd-Frank Act), but, there too, shareholders in the US are unlikely to vote against executive pay proposals. For example, only 2 percent of pay plans across all publicly listed companies (123 out of 4,113) which were put to shareholders in 2014 failed to receive majority support. On average, pay plans received 89 percent support from shareholders in the advisory vote, with small- and mid-cap companies more likely to see their pay plans rejected (ProxyPulse 2014: 6).

Belgium has given shareholders in listed companies an annual advisory vote on the company’s remuneration report since 2010. Since then remuneration reports have consistently received more than 90 percent approval from shareholders. Shareholders in Belgium also receive certain rights to approve variable remuneration plans where criteria are met (Thomas and Van der Elst 2013: 27-30).

In October 2013, the UK introduced a right for shareholders in listed companies to have a binding vote on executive pay policy at least once every three years (s79(4) Enterprise and Regulatory Reform Act 2013). The Netherlands and Sweden also have binding votes on pay policy. Shareholders in Sweden have an annual vote on the ‘remuneration guidelines’ in line with which the managing director and senior management are remunerated, and which must cover the various types of remuneration, as well as estimate the total cost to the company. Executive pay in Sweden is considered ‘moderate’, and companies’ guidelines are generally approved by at least 90 percent of shareholders. The one exception to this occurred when the Swedish government used its blockholding to reject the remuneration guidelines at TeliaSonera (Thomas and Van der Elst 2013: 47-52). Shareholders in the Netherlands have had a right since 2004 to approve the remuneration policy. In companies with two tier boards it is considered best practice for the supervisory board to draft the policy, and the employees’ council has a right to provide the shareholders with their opinion of it (Thomas and Van der Elst 2013: 52-8). Shareholder approval is much more fine-grained in the Netherlands than in Sweden, with shareholders able to vote on individual board members’ salaries (2:135 BW). While shareholders do not generally oppose companies’ plans, bonus plans have been rejected by 57.1 percent of shareholders at Royal Dutch Shell in 2008, and extraordinary bonuses were rejected twice by shareholders at Vastned Retail in 2008 and 2009. There has also been significant opposition in other large listed companies,
including Heineken and Randstad, where it was proposed to raise salaries and bonuses following large takeovers whilst restricting dividends.

Since the UK only introduced a legally binding say on pay in 2013, it is too early to draw any definitive conclusions as to its effects in a context where shareholders are widely dispersed, although the signs are that shareholders are not voting against remuneration policies in significant number. For example, recent research by Deloitte (2015) reported that in 2015, the ‘median level of votes in favour of the remuneration policy is... 96% so far this year’. It also noted that there has not yet been ‘a vote against the remuneration policy of a FTSE 100 company in the 2014 or 2015 season’. Likewise it is difficult to generalise from the experience in the Netherlands and Sweden, because shareholdings there are more concentrated than in the UK, and so ‘there already is close supervision of pay levels by a concentrated owner with strong incentives not to overpay executives’ (Thomas and Van der Elst 2013: 3). A recent cross-country survey of 39 countries undertaken for the US Federal Reserve Board concluded that firms subject to say on pay laws experience lower CEO pay growth (Correa and Lel 2014). Research on the UK’s experience with an advisory vote concluded that ‘investors perceived say on pay to be a value enhancing monitoring mechanism and were successful in using say on pay votes to pressure firms to remove controversial pay practices and increase the sensitivity of pay to poor performance’ (Ferri and Maber 2013). Neither of these studies expresses any view on whether ‘say on pay’ results in executive pay which is more oriented towards the long-term interests of the company.

The Commission is now proposing EU level rules on shareholder voting on executive remuneration. The Proposed Directive draws on the practice of those Member States which go the furthest in this regard, giving shareholders a binding vote on remuneration policy and an advisory vote on the remuneration report, and requiring companies to disclose and justify their remuneration policies.4 Given the limited adoption to date of

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4. At the time of writing, the European Parliament had reached agreement on an amended text (on 8th July 2015) by an overwhelming majority. The text has now been sent back to the Committee on Legal Affairs, with Sergio Cofferati as rapporteur. That amended text (European Parliament (2015)) adds a provision that ‘Member States may provide that the votes by the general meeting on the remuneration policy are advisory.’ The introduction of this change, which significantly alters the corporate governance effects of the Proposed Directive, along with the proposed requirement of country-by-country tax reporting for large corporations (discussed briefly below), means that the amended Proposed Directive is likely to create controversy in both the Commission and the Council. This suggests that considerable further negotiations will be necessary before the Proposed Directive can become law.
either advisory or binding ‘say on pay’ regimes in the EU, coupled with wide differences between Member States in terms of shareholder concentration, there can be no certainty either as to how this power will be exercised or as to the effects it will have. Hence the Proposed Directive represents a major experiment in corporate governance.

The Proposed Directive gives shareholders the power to vote on remuneration policy at least once every three years (Art 9a(1)). This is very similar to the requirements of the UK’s Enterprise and Regulatory Reform Act 2013, which amended the Companies Act 2006. This provision of the Proposed Directive will allow shareholders to veto a remuneration policy that they oppose. As a general principle, shareholders are unlikely to vote against a policy which uses stock options to align executive remuneration with the share price due to widespread business practice and culture. Remuneration policies will be likely to contain claims that incentives are aligned with the long-term interests of the company (for example ‘executive remuneration is tied to the current stock price which economic analysis shows is the best guidance available as to the future performance of the company’). Indeed, there is a danger that shareholders with a very short-term orientation might use these new powers to push back against proposals to use longer-term incentive structures.

The Proposed Directive requires a company’s remuneration policy to ‘explain how it contributes to the long-term interests and sustainability of the company’, and give full details of fixed and variable pay (article 9(a)(3)). Notably, it must explain ‘the ratio between the average remuneration of directors and the average remuneration of full time employees of the company other than directors and why this ratio is considered appropriate’. In requiring disclosure of a comparison between average board pay and average employee pay in the policy, the Proposed Directive builds on, but goes beyond the UK’s current approach, which requires (inter alia) remuneration policies to explain how each component ‘supports the short and long-term strategic objectives of the company’; ‘offer an explanation of the differences (if any) in the

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5. In the Proposed Directive, ‘Director’ is defined in article 1(I) as ‘any member of the administrative, management or supervisory bodies’. We suggest that this should be changed to include only executive directors so as to exclude part-time non-executives, whose pay is much lower and who do not receive stock options. The amendments adopted by the European Parliament (European Parliament 2015) extended the definition of director to include ‘chief executive officer and deputy chief executive officers, where they are not members of administrative, management or supervisory bodies’.
company’s policy on the remuneration of directors from the policy on the remuneration of employees generally; include a statement of ‘how pay and employment conditions of employees (other than directors)... were taken into account when setting the policy for directors’ remuneration’; and state ‘whether, and if so, how, the company consulted with employees when drawing up the directors’ remuneration policy’ (UK SI 2013 No. 1981, Regulations 26(a), 27(e), 38 and 39(a)).

In addition, companies should include a ‘clear and understandable remuneration report... including all benefits in whatever form, granted to individual directors’ (Art 9b(1)) in their annual corporate governance statements. The Proposed Directive then gives shareholders a right to vote on that remuneration report (Art 9b(3). Although this vote is merely advisory, the company is expected to disclose the outcome of the vote in the next year’s remuneration report, and explain whether the vote was taken into account, and if so, how. This requirement echoes the UK’s requirement.

This provision of the Proposed Directive may allow institutional investors to express dissatisfaction and demand changes to incentives that better align directors’ remuneration with the long-term interests of the company, its shareholders and other stakeholders. This opens a formal channel of communication which will supplement the informal channels intended to be opened through the requirement that institutional investors publish policy on engagement, which was discussed above. However, it is difficult to see how companies are supposed to interpret a vote against the remuneration report. Presumably if institutional investors reject a remuneration report, they could communicate the reasons for this informally to members of the board of directors, who could then communicate their response to this publicly.

However, given recent experience in the EU and the US with ‘say on pay’ as discussed above, we consider that it is unlikely that institutional investors will reject either remuneration policies or remuneration reports in meaningful numbers. As such, we are not convinced that these provisions will lead to the development of different forms of incentives which are better aligned with the long-term interests of the company. The UK’s experience with an advisory vote on remuneration reports over more than a decade suggests that pay practices will not change. If shareholders did express dissent about the structure and timeframes of executive incentives, either through the advisory vote or informally in dialogue with
senior executives, this did not lead to any discernible changes in the methods used by large companies to remunerate their executives.

The Proposed Directive is also noteworthy for what it omits, namely a cap on stock options and other bonuses. The Capital Requirements Directive capped the variable pay of directors of financial institutions by reference to their fixed pay. This can be justified on the grounds that the social costs of excessive bonus culture in the financial sector far exceed its social benefits. While fixed pay will go higher, this ought to call forth exactly the type of institutional shareholder activism on which policy-makers are pinning most of their hopes on, at least in less profitable years (Johnston 2014). It remains to be seen whether this occurs. This approach was not taken in the Proposed Directive, which leaves the matter of executive pay entirely to shareholders. The rationale for this less restrictive approach is presumably the familiar shareholder primacy mantra that shareholders are the sole residual claimants of the company, and that they alone bear the risk of its failure. This is not the place to challenge that particular claim, other than to note that many other stakeholder groups are dependent on companies, and are strongly affected by their success or failure (see e.g. Stout 2001: 1192-95).

More generally, in leaving executive pay in the hands of remuneration committees and shareholders, the Commission appears to be assuming that executive pay is a purely private matter which only concerns shareholders and companies. This assumption ought not to have survived the financial crisis, and is causing the Commission to miss out on other sources of influence which might steer companies away from the short-term incentives that characterise executive pay at present. Moreover, if institutional investors are indeed responding to zero interest rates by adopting an increasingly short-term perspective, this provision of the Proposed Directive might have the perverse effect of allowing shareholders to give their approval to pay plans which actually focus more – rather than less – intensely on short-term shareholder wealth maximisation at the expense of the longer-term interests of the company, its committed shareholders and its stakeholders.

Furthermore, some research suggests that increased disclosure of executive compensation may have the counter-intuitive effect of increasing overall pay. The public availability of information leads to media attention and allows for direct comparison of pay levels across firms, which has been posited to be at least partially responsible for the
rapid rise of executive pay, further assisted by compensation consulting firms (Ariely 2009; Schmidt 2012; Faulkender and Yang 2013). The disclosure rules which facilitate the operation of shareholders’ ‘say on pay’ may therefore exacerbate intra-firm inequality, even if they slow the growth rate of CEO pay.

Other ways of governing executive pay in pursuit of long-termism are conceivable. Restrictions might be imposed on variable pay (including stock options), by, for example, following the Capital Requirements Directive and capping bonuses relative to fixed pay in all listed companies. This would continue to provide incentives to executives, but would reduce their myopic focus on the share price. Additionally, pay policies could measure performance against both financial and non-financial criteria to capture a range of issues often ignored by stock price, including innovation; and environmental, social and governance matters. This could be done by referencing existing standards such as the Integrated Reporting Framework or the Global Reporting Initiative (GRI) Guidelines.

Despite our reservations about the possible effects (or lack thereof) of giving shareholders a ‘say on pay’, we support the detailed disclosure requirements contained in the Proposed Directive relating to the remuneration policy. They will provide essential information to shareholders in deciding whether to approve the policy, and to stakeholders when they deal with companies. In emphasising the growing gap between board level executive remuneration and the remuneration of regular employees, and raising questions about the sources of wealth generation within large companies, there is a possibility that the provisions on disclosure might trigger activism on the part of institutional investors.

Looking beyond reliance on shareholders, our view, which we expressed at a conference held at the European Parliament, is that it would be desirable for the Proposed Directive to go further and give employees a right, via their representatives, to express a view on pay ratios and the likely effects of the pay policy on the long-term interests of the company. Following debates in the European Parliament, the Cofferati Report (Cofferati 2015) proposed that Member States should be required to allow employees and other stakeholders to express a view on the remuneration policy before it is submitted to the shareholders. This would have represented only an incremental change from the approach adopted by
the UK in 2013, which, as we saw above, encourages companies to consult their employees on remuneration policy. The views of employees could then be communicated by the company to its shareholders using the communication channels opened up by the provisions on shareholder identification discussed above. The different perspective offered by employees’ views, as well as their insider status, might have some influence on shareholders who are deciding whether to support a proposed remuneration policy. In the event, and regrettably, the amendments adopted by the European Parliament in July 2015 did not include such a right for employees; instead, the Parliament’s text simply states, in the preamble, that there is a need for ‘additional measures to ensure a greater involvement of all stakeholders’ in corporate governance (European Parliament 2015). This would leave the question of whether employees should be entitled to express a view on remuneration to the Member States and to individual companies. The final form of the Proposed Directive is, of course, dependent upon further negotiations between the Council, Commission and Parliament.

Two additional noteworthy proposals in the Cofferati Report were to introduce a requirement of country-by-country tax reporting (article 2) and to require Member States to create incentives for long-term shareholding (article 3a). While it is outside the scope of this chapter to explore the details of country-by-country reporting, it represents a significant step forward for corporate transparency. The proposal adopted by the European Parliament in July 2015 requires public disclosure of tax payments broken down by Member State, rather than confidential disclosure to regulators as recommended by the OECD (OECD 2015).

The long-term shareholding provision would have required Member States to choose between several forms of incentives, whether it be additional voting rights, tax incentives, loyalty dividends or loyalty shares. This proposal did not pass the plenary vote in Parliament of July 2015. These types of incentive structure currently exist in France and Italy. For example, France’s Loi Florange (2014) allows shareholders to automatically acquire double voting rights after two years unless two thirds of shareholders vote to overturn it. The law offers some degree of protection against unwanted takeovers, but has been criticised for its potential to entrench and insulate management (Economist 2015), demonstrating the challenge of crafting effective incentives for pro-social behaviour. One way to avoid these issues would be to use tax incentives,
for example restructuring capital gains taxes so that they are higher where shares are sold during the first two years of ownership, and then gradually lowered over subsequent years.

4. Conclusion: beyond shareholder empowerment – other ways to long-termism

As we suggested above, in relying exclusively on shareholder empowerment to deal with the problem of short-termism, the Commission is missing out on a whole range of mechanisms which could be used to reorient corporate governance towards the long-term. In this final section we will set out a number of proposals which offer an alternative to the current shareholder-centric approach to corporate governance and company law. If adopted, these proposals would contribute to making European companies and the European economy more socially and environmentally sustainable, as well as more innovative. The starting point is that companies should pursue their long-term interests, whilst respecting the interests of shareholders and other stakeholders. Companies can only continue to operate in the long-term if they take account of their environmental and social context. Steering companies toward taking account of long-term ecological and social sustainability will require numerous changes to the legal and regulatory framework at the national and EU levels, as well as improvements to business practice and culture.

As a broad policy matter, EU company law should encourage or require companies to take into account the long-term interests of all stakeholders, including workers, creditors, communities and shareholders, as well as broader social costs and harm to the environment arising out of their operations. This might be facilitated through provisions which allow these different stakeholder and affected groups to express their views to corporate management and shareholders. As a starting point, the Commission should consider employee representation on remuneration committees as a means to better long-term alignment between directors’ incentives and the long-term interests of the company. Going further, minimum standards for employee participation in the governance of listed companies across the EU would provide a meaningful counterweight to capital market pressure, and so would complement the Proposed Directive and its goal of increasing long-termism in decision-making. Whilst the European Commission recognises that many Member
States require employee representation at board level (see e.g. Commission 2008), its approach, since the crisis, has been to focus on facilitating employee share ownership rather than strengthening employee participation through increased rights to information, consultation or direct board participation (see Commission 2010: 17). This is, of course, entirely compatible with a shareholder primacy approach to corporate governance, and is in line with the Commission’s broader approach to corporate governance, which, as discussed above, tends to adopt solutions from the UK.

The innovative capacity of companies should be nurtured and protected by the law. EU company law could require all Member States to allow companies to specify long-term purposes in their constitutional documents. These statements of purpose might cover environmental, social or scientific goals. In addition, EU company law could require that companies be able to lock-in those purposes against opportunistic change by short-term shareholders (perhaps by requiring a supermajority to amend the purpose clause) (Segrestin and Hatchuel 2012).

EU company law could specify more clearly the societal purpose of companies generally. For example, it might create an explicit duty for directors to pursue sustainable value. At present, the societal purpose of companies is not explicit in law, and this has created space for short-termism to flourish (Sjåfjell et al. 2015). A clear statement of purpose would: introduce legal clarity; complement many of the other suggestions set out above; and create a level playing field for companies that wish to contribute to a sustainable and innovative economy.

The inclusion of long-term (social, environmental or scientific) purposes, either within the corporate constitution or in national companies legislation (as appropriate), would facilitate informed shareholder engagement. It would also prevent the reduction of corporate purpose to the shareholder interest in short-term financial returns. Finally, it would allow enterprises to pursue long-term strategies (especially those involving R&D which entail a high degree of uncertainty), and so contribute to long-term economic, social and environmental sustainability.

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6. Some form of employee representation on boards is found in 17 Member States and Norway (Conchon 2011).
Together, the articulation of long-term purposes and the introduction of a plurality of voices into corporate governance would allow a better alignment of corporate decision-making with the common good, and operate as a brake on the current systemic tendency towards short-termism.

To summarise, shareholder empowerment alone is neither sufficient nor acceptable. In those jurisdictions in which it has been tried, there is no evidence that shareholder empowerment prevents short-termism. Indeed, there is a danger that it might actually exacerbate the problem. Equally, however, it is clear that the current system is not sustainable. Current remuneration practices, which give executives enormous incentives to prioritise short-term returns to shareholders at the expense of companies, their long-term shareholders and their stakeholders, cannot continue. Remuneration committees have shown themselves to be incapable of producing incentive contracts which address the long-term. Indeed, and potentially in breach of their duty of care to the companies in question, they have not even been able to insert meaningful clawback provisions in executive employment contracts, as recommended by the OECD (2014: par.112).

We reject the binary choice between leaving corporate governance in the hands of boards alone or empowering shareholders. We support shareholder empowerment, subject to our reservations above. However, board and shareholder empowerment must be counterbalanced by meaningful legal requirements of stakeholder participation in various aspects of corporate governance. This could begin with a soft law requirement of employee representation on remuneration committees, before moving on to a hard law requirement of minimum levels of employee board-level participation across listed companies. Employees make illiquid, non-diversifiable investments in the companies for which they work, and so have a longer-term perspective than many shareholders. If policy-makers were to allow them to express that perspective in corporate governance processes, the problem of short-termism would be significantly reduced.
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Towards long-termism in corporate governance: the Shareholder Rights Directive and beyond


Chapter 2
The Kay Review of Equity Markets – game changer or missed opportunity?

Janet Williamson

1. Introduction: background to the Kay Review

This chapter analyses the Kay Review of Equity Markets and Long-term Decision Making, which published its final report in July 2012. Although the Review focused on the UK, it nevertheless has significance for Europe as a whole. The Review has received significant attention outside the UK due to the quality of its analysis of the problem of short-termism in corporate governance, a problem which affects companies and investors beyond UK borders. The Review’s analysis is largely supported by the British Trades Union Congress (TUC). However, the Review’s recommendations, although quite detailed, focus largely on voluntary ‘soft law’ measures rather than the fundamental reform of corporate governance and the role of shareholders within it that the TUC believes is necessary.

In June 2011, the Right Honourable Vince Cable, then Secretary of State for Business, Innovation and Skills (BIS), asked economist and author Professor John Kay to carry out a review of the effect of equity markets on the competitiveness of UK business. The financial crisis that had peaked less than three years earlier had created a renewed interest in the role of shareholders in corporate governance. The recognition that shareholders had at best failed to curtail excessive risk taking on the part of financial institutions, or at worst had encouraged it, raised wider questions about the relationship between investors and the companies whose shares they own. These questions lay at the heart of the Kay Review.

The terms of reference of the Kay Review were to ‘consider the ways in which the mechanisms of control and accountability provided by UK equity markets, and the behaviour of the agents in that process, affect the performance of UK businesses. The review will give particular emphasis to the ability of managers to focus on the actions needed to enhance the long term competitiveness of UK based firms and achieve the best long term returns for UK savers’ (BIS 2011: 1).
A review of equity markets had particular significance in the UK context. Firstly, UK pension provision relies significantly on funded occupational pension schemes that have traditionally invested heavily in equities. So the performance of equity markets has a significant impact on the standard of living of retirees and the expectations of working people of their likely retirement income.

Secondly, shareholder engagement plays a vital role in the UK’s system of corporate governance. Company directors are required under UK law to promote the success of the company for the benefit of shareholders. At the same time, shareholders have significant rights in relation to companies, including voting on all company resolutions, voting on remuneration reports and electing company directors each year at Annual General Meetings. It is also accepted that institutional shareholders, especially those with significant holdings, are able to meet with company management and non-executive directors on a regular basis to discuss ongoing issues or raise concerns. So, shareholders can have a significant impact on the priorities and strategic direction of company boards and therefore on company performance and workers.

John Kay’s initial speech launching the review defined the core purposes of equity markets as being:

— to enhance the performance of UK companies; and
— to provide good returns to savers and pensioners through the activities of these businesses (Kay 2011).

A key strength of the Kay Review stems from this definition of what, fundamentally, equity markets are for. Too often other criteria such as liquidity are assumed to be a positive end in themselves, which can then be used to justify market characteristics that may, while increasing liquidity, not in fact contribute to long-term company performance or returns. The Review’s clarity that everything other than enhancing the performance of UK companies and returns to savers is only important as a means to these two ends was a significant contribution to the debate.
2. Core findings of the Kay Review

The Kay Review’s final report was published in July 2012. It concluded that equity markets have contributed to short-termism, or poor long-term decision-making, on the part of companies. Kay defines short-termism as a tendency to under-investment in physical assets or in intangibles, including employee skills, product development and reputation and a tendency to what he calls hyperactive activity on the part of executives – including restructuring, financial engineering, mergers and takeovers – at the expense of focusing on the operational fundamentals of the business. Evidence provided in the Review for the existence of short-termism includes relative R&D rates over time, data on mergers and acquisitions plus examples of poor long-term company decision-making that led to the destruction of company value (such as GEC and ICI).

An argument with particular significance in the UK, where shareholder engagement is ascribed a key role within the corporate governance system, is that the problem is not the amount of engagement with shareholders that takes place, but the quality of that engagement, and that equity markets encourage exit (the sale of shares) over voice as a means of engagement. Kay notes that in the examples of poor decision-making discussed in his report, many were strongly supported by shareholders. For the TUC, this is significant, as it supports our argument that there are fundamental flaws with the shareholder value model of corporate governance (see TUC 2013).

The Review assesses the main causes of the problems in equity markets as the following:

— Shareholding in UK companies has become increasingly fragmented. The proportion of shares held by large UK insurance companies and pension funds and individuals have all declined, while foreign shareholding has significantly increased.

— There has been an ‘explosion’ of intermediation in equity market investment. Kay ascribes this to a desire for ‘professionalism’ and a decline in trust in investment relationships. Intermediation, he argues, creates increased costs for investors, the potential for misaligned incentives and a tendency to view market effectiveness through the eyes of intermediaries, rather than from the perspective of companies or end investors. In the light of Kay’s
definition of the purpose of equity markets – to serve the interests of savers and companies – this has particular resonance.\footnote{On the issue of the ‘lengthening of the investment chain’ see the chapter by Habbard in this volume.}

— Market commentators and regulators have been unduly influenced by the ‘efficient market hypothesis’, which Kay describes as ‘a poor basis for either regulation or investment’. This has led regulatory policy to focus on information disclosure as the response to conflicts of interests and/or imbalances of knowledge across the investment chain, which has not proved effective.

— The role of asset managers comes under particular scrutiny. Kay notes that they have become dominant in equity markets, both in terms of voting and engagement and stock selection. He distinguishes between an investment approach based on a view of a company’s fundamental value and a trading approach based on expectations of movements in the share price, and concludes that ‘current levels of trading activity exceed those necessary to support the core purposes of equity markets.’

— The incentives for active asset managers, based on short-term relative performance, encourage them to focus on the behaviour of other market participants, rather than the fundamentals of the businesses in which they invest. Kay notes that competition between asset managers on the basis of relative performance is essentially a zero-sum game; the asset management industry can only benefit savers as a whole if the industry as a whole is working effectively to boost company performance overall.

This analysis provides a very valuable account of the flaws of the current system and matches much of the TUC’s own analysis of the operation of equity markets over recent years. Such an analysis being put forward so clearly by a highly respected economist in a government-sponsored review has undoubtedly changed the terms of debate on the operation of equity markets and made it harder for insiders and/or vested interests to defend the status quo. This is helpful for all those who, like the TUC, argue for fundamental reform of equity markets and corporate governance.
The Review set out a set of principles which it argues should guide practice and regulation and a number of recommendations (see Appendix to this chapter). Whether these are sufficient to address the problems the Review so cogently outlines is questionable, as will be discussed below.

The principles broadly concern the establishment of relationships based on trust, stewardship, fiduciary duty and a long-term perspective throughout the investment chain. All ten principles are easy to support and there is no doubt that, were they to be fully reflected in the behaviour of all participants in the investment chain, many, if not all, the problems described in the Review would cease to exist. However, the Review’s own analysis makes clear that the problems within investment chains stem in the main from the structure of equity markets and the incentives of participants. It follows that successful reform will need to address these key areas, and that the principles presented by the Review should be seen as informing or as part of a wider set of reforms, rather than as necessarily being efficacious in their own right.

A key recommendation of the Review was that company directors, asset managers and asset holders should adopt Good Practice Statements to promote stewardship and long-term decision-making. Again, it is easy to support the contents of the three Good Practice Statements included in the Review; the problem lies in their being voluntary on the one hand and normative statements of behaviour on the other. As such, as with the Review’s principles, it is not clear through what means these Statements on their own would have an impact.

The Review argues that through greater involvement investors could contribute more to the performance of British business, and, in consequence of this recommends that ‘Asset managers should have greater incentives to engagement. Active asset managers should typically have more concentrated portfolios [and] [t]here should be more opportunity for collective action by asset managers’ (Kay 2012: 50).

The TUC has long argued (along with others) that the very number of shareholdings held by asset managers makes it impractical for the latter to engage with all the companies whose shares they hold on all issues for which shareholders are ultimately responsible: there is simply not enough capacity within the organisations to carry out the work. Holding more
concentrated portfolios would provide a solution to this. However, there is a great difference between asserting that this should happen and making it happen in practice. Just recommending that asset managers should hold more concentrated portfolios takes no heed of the reason why asset managers hold the shares of such large numbers of companies, which is precisely to diversify their risk. While other recommendations of the Review seek to encourage asset managers to take a different approach to risk (principle 8 says that risk should be seen as the failure of investments to deliver reasonable returns to savers and not in relation to tracking a benchmark), the approach behind holding such large numbers of shareholdings is so hard-wired into the industry that much more than wise words will be required to change it.

A significant and related recommendation was that an investors’ forum should be established to facilitate collective engagement. This could address the inefficient use of resources created by investors carrying out many separate engagements and the disincentive to engage that is created by the fact that successful engagement produces gains for all investors equally, regardless of the resources each has put into the process.

To take this recommendation forwards, a Collective Engagement Working Group was established by the three main organisations representing institutional investors: the National Association of Pension Funds (NAPF), the Investment Managers’ Association (IMA) and the Association of British Insurers (ABI). Bizarrely, the Local Authority Pension Fund Forum, despite its established track record in carrying out engagement with companies on behalf of its 64 members, was not invited to participate in the group. In October 2014 the Investor Forum was quietly launched, publishing a discussion paper setting out its proposed approach. Its board includes John Kay and a range of asset owners and asset managers and, perhaps more surprisingly, one company Chairperson. The press release for its launch states that ‘All long-term investors in UK companies, including international investors, are invited to join the Investor Forum’ (Investor Forum 2012).

It is worth noting that the NAPF, the IMA (and its predecessor organisations) and the ABI had previously been key members of the Institutional Shareholders’ Committee (ISC), producing a set of principles

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2. In 2014 the IMA merged with the Investment Affairs Division of the ABI to create The Investment Association.
on ‘The Responsibilities of Institutional Shareholders’ in 1991 which were then updated over the years. This document formed the basis for the first draft of the UK Stewardship Code launched in 2010. The ISC during its many years of existence neither promoted collective engagement effectively nor acted as a positive force for progressive reform of corporate governance. The IMA, representing the asset management industry, showed itself highly resistant to change, strongly opposing, for example, the TUC’s campaign for mandatory fund manager voting disclosure.

The new Investor Forum includes a far wider range of representatives on its Board than were included within the ISC, including those from the pension funds Railpen and USS, which should improve its chances of becoming a more useful and progressive force than its predecessor. At the time of writing in Spring 2015, it is too early to say what the Investor Forum may bring about in terms of promoting collaborative engagement and changing the culture and practice of equity markets.

Perhaps the most potentially significant recommendation of the Review was that fiduciary standards should apply to relationships along the whole investment chain and should not be capable of being over-ridden by contracts. The Review argued that regulators at UK and EU level should review existing regulation and orchestrate a shift towards fiduciary standards in all relationships in the investment chain that involve discretion over the investments of others or investment advice. In addition, the Law Commission was asked to review the concept of fiduciary duty ‘to address uncertainties and misunderstandings on the part of trustees and their advisers’ (Kay 2012:13).

In theory, the application of fiduciary standards to relationships along the investment chain could solve many of the problems with the operation of equity markets. Fiduciary standards are incompatible with conflicts of interests (or at any rate, poorly managed conflicts of interests) and with decision-making that reflects the interests of the advisor or intermediary, rather than the end beneficiary. Opaque and unreasonable charges are also incompatible with the application of fiduciary standards. There is, however, a question as to whether applying fiduciary standards along the investment chain is compatible with the complexity that now characterises that chain. It is far from clear that every player in the

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investment chain is equipped with the knowledge and understanding of
the needs of end beneficiaries to be able to carry out a fiduciary duty to
beneficiaries effectively. While the TUC would strongly support measures
to reduce the complexity of that chain, it is not clear that applying
fiduciary standards along the chain would necessarily have that effect.
However, the aim of ensuring that the actions of every player in the
investment chain serve the interests of end beneficiaries affected by their
actions is one that the TUC would strongly support.

The Law Commission, as requested, carried out a review of fiduciary duty,
producing a detailed consultation document and publishing its final
report in July 2014. It did not recommend codifying fiduciary duty (as
had been done with directors’ duties in the 2006 Companies Act). It
concluded that the Kay Review’s recommendation that fiduciary
standards should apply along the investment chain could not be achieved
through reform of fiduciary duty, arguing that ‘the principles set out in
the Kay Review are so far removed from the courts’ interpretation of
fiduciary duties that we do not think that it is possible to create the first
from the second’ (Law Commission 2014: 207).

It did, however, set out its view on the relationship between fiduciary duty
and consideration of social, environmental and ethical standards, arguing
that all factors affecting long-term financial performance, including
environmental, social and ethical issues, should be considered, but that
it was up to fiduciaries such as pension fund trustees to evaluate which
risks are material and how to take them into account. In addition, the
Law Commission argued that trustees could take account of non-financial
factors if they had good reason to think that scheme members would
share their concern and the decision did not involve a significant risk of
financial detriment to the fund.

At the time of writing, the Department for Work and Pensions was in the
process of consulting over amending the regulations governing trustees’
duties to reflect the Law Commission’s conclusions. The Pensions
Regulator has updated its guidance to reflect the Law Commission’s
report, with more amendments planned over the year ahead. In addition,
the government has requested that the Financial Conduct Authority
consider to what extent current regulation aligns with the principle of
fiduciary duty (though how practical it would be to amend detailed rules
to reflect the broad principle of fiduciary duty to end beneficiaries
remains to be seen).
The clarification by the Law Commission that trustees should take account of social, environmental and ethical factors where they are or may be financially material is helpful in clarifying an issue that has been the subject of considerable misunderstanding since the case of Cowan vs Scargill in 1985. Useful work had already been done by Freshfields (2005) and the United Nations Environment Programme (UNEP 2009) on the subject, but the Law Commission’s role as a statutory body lends weight to its conclusions, and it is positive that the latter have received good publicity in the investment world. The issue of extending fiduciary duty along the investment chain, on the other hand, seems to have fallen into the long grass (unless the Financial Conduct Authority should come up with amendments to its rules to reflect this aim).

Another important recommendation of the Kay Review was that asset managers should make full disclosure of all costs, including transaction costs. This is something for which the TUC has advocated strongly. Lack of transparency on the extent of charges and the basis on which they are applied is a major cause of conflicts of interest along the investment chain, and addressing this is a prerequisite for ensuring that equity markets serve the interests of end beneficiaries, rather than market participants.

It is particularly welcome that the Review stipulated that, in addition to other costs, transaction costs should be disclosed. Clarity about the direct costs of trading in shares should help to expose the extent to which fund managers are pursuing strategies based on share trading, as opposed to long-term shareholding, even for clients like pension funds that are investing over a very long timeframe. Information about transaction costs is also a necessary ingredient for an assessment of the effectiveness or otherwise of this approach.

Since the Kay Review, the UK government has introduced requirements for providers of workplace pension schemes to report annually on value for money within the scheme, including administrative charges and transaction costs. The main spur for this was a highly critical study of the market in defined contribution pension schemes carried out by the Office of Fair Trading in the context of mandatory automatic enrolment into pension schemes (OFT 2013). Greater transparency regarding administrative and transaction costs should help to address the conflicts of interest identified in the Review.
As noted above, Kay argued that the incentives for active asset managers, based on short-term relative performance, contribute to short-termism in equity markets. To address this, the Review recommended that asset management firms should design remuneration to align the interests of individual asset managers with the interests and timescales of their clients. It specifically recommended that a long-term performance incentive in the form of an interest in the fund should be held by the fund manager for the duration of responsibility for that fund.

While agreeing that asset managers’ remuneration should not depend on short-term fund performance, the TUC is far from convinced that trying to create incentives that link the financial interests of asset managers and clients will work. The TUC is sceptical about the effectiveness of performance-related pay. Research has shown performance-related pay to be ineffective in terms of boosting motivation for complex tasks (Ariely 2010). There is also a question as to whether using financial incentives sends the right signal to asset managers in terms of the underlying purpose of their role – to serve the needs of other people for financial security in the future – and the types of behaviours required to deliver this. The Review argues forcefully that there is a need to move towards relationships based on trust, rather than contractual complexity, along the investment train. However, the use of financial incentives to mould behaviour assumes that a desire to make money, rather than to safeguard beneficiary interests in their own right, is the way to motivate and direct asset managers, which is surely not the best way to generate relationships based on trust. There is also the difficulty of designing remuneration packages that align the interests and timescales of asset managers with end beneficiaries - given the very long timescales of pension funds beneficiaries, it is far from clear how this could be done. The experience of designing performance targets for executive remuneration is not promising in this regard.

The TUC would support a move away from performance-related pay for both asset managers and company directors and believes that much simpler remuneration packages with greater reliance on basic salary would reduce the scope for conflicts of interest, boost transparency and help to stop the inexorable increase in the gap between the pay of company directors and asset managers and that of ordinary workers. Nonetheless, the Review’s recommendation in this area would be an improvement on the status quo. However, no detail is given on how it should be implemented or monitored and it is not clear that it has had any impact on practice to date.
The recommendation that received most attention when the Review was published was that mandatory quarterly reporting should be abolished, perhaps because this was the only one that required an explicit change in the law. The TUC supports this reform, although to the extent that reliance on quarterly reporting may be a symptom of short-termism as much as a cause, it will be interesting to see how much impact it has on short-termist behaviour. The UK’s Financial Conduct Authority removed the requirement for listed companies to publish quarterly reports (or interim management statements) in November 2014, following changes to the EU Transparency Directive. Since then, a few large companies have announced that they are no longer going to produce first and third quarter reports, including National Grid, United Utilities, Diageo and G4S. National Grid’s Finance Director commented that the change could save up to a month of senior management time a year (FT 2015a).

Some asset managers and the Financial Reporting Council have publicly supported companies that have ended quarterly reporting and Legal & General Investment Managers, one of the UK’s largest fund managers, recently wrote to all FTSE 350 companies arguing that providing quarterly updates offers little value for companies operating in long-term business cycles (FT 2015b). However, the market reaction in terms of share price suggests that not all investors are convinced: National Grid’s shares fell nearly 1 per cent after the company’s announcement of ending quarterly reporting, while FTSE 250 coal producer New World Resources saw its shares drop 22 per cent when it said in 2013 that it would replace regular guidance with ‘timely’ updates. But this has not prevented other companies from following their example and it seems probable that not issuing quarterly reports will become both increasingly common among companies and increasingly accepted by investors.

Mergers and takeovers could be seen as the dog that didn’t bark in the Kay Review. The Review is very critical of the effect of mergers and takeovers on company performance and merger and takeover activity is included as an example of the ‘hyperactivity’ on the part of company managers that characterises short-termism. Mergers and acquisitions contributed to some of the examples of company failure included in the Review. The Review argues that the market for corporate control does not ‘ensure that the management of corporations is always placed in the most capable hands’, and that the UK cannot ‘be wholly indifferent to the location of corporate headquarters’. It also argues that the limitation of the grounds for intervention in mergers and takeovers to competition
grounds (brought in by the Enterprise Act of 2002) ‘has not necessarily been beneficial’ (Kay 2012: 58-59).

Despite this position, the Review’s one recommendation to address this is that ‘[t]he scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves’ (Kay 2012:62). It argues that the government should make use of its formal and informal authority to influence potential takeovers. However, its main argument is that the development of stewardship activities and a move away from a trading culture would be the most effective remedies to the current situation.

Given the link between the way mergers and takeovers operate in the UK and short-termism, it is disappointing that the Review does not give more attention to this area and it is hard to see its one recommendation as an adequate response to the situation it describes. There is little discussion of other proposals for reform of mergers and takeovers, nor of how the regimes in other countries operate. The argument that the development of stewardship activities would provide the best solution on this places great faith in stewardship leading to a different approach to company performance on the part of both investors and company management. It also relies on the other proposals in the Review succeeding in boosting stewardship to the extent that additional reform of mergers and takeovers is unnecessary.

The TUC believes that reform of the UK mergers and takeovers regime is both necessary and urgent, and calls for the establishment of a body that would operate at arm’s length from government and to whom potential mergers could be referred on grounds of long-term company impact, rather than just competition as at present.4

There are, however, some interesting points of comparison between the two highest profile takeover bids for UK companies in recent years – Kraft’s hostile takeover of Cadbury in 2010 and Pfizer’s attempted takeover of AstraZeneca in 2014. In 2011, largely as a response to the Kraft-Cadbury takeover, the UK’s Takeover Code was amended to make clear that company directors are not required to recommend a bid to shareholders on the basis of a high offer price if they do not believe the bid is in the long-term interests of the company. The Kay Review briefly

4. For more information on the TUC’s proposals on mergers and takeovers see TUC (2010).
noted that directors’ legal duties to promote the long-term success of the company for the benefit of its members addressed the issue of whether directors can legally recommend that a high bid be rejected. In its response to the Kay Review, the government supported this conclusion and referred to the Takeover Code amendment on that point.

The response of the AstraZeneca board to Pfizer’s hostile bid was notably different from that of the Cadbury board during the Kraft bid. The Cadbury board’s main argument against the takeover was that the share price offered was too low and did not fully reflect the company’s true value. Consistent with this approach, when Kraft finally raised the offer price, the board recommended that shareholders accept the bid. The AstraZeneca board, on the other hand, did not put the offer price at the centre of their defence, arguing instead that AstraZeneca would be more successful as an independent company and that the Pfizer bid would lead to reductions in R&D, skills and the company’s drug development programme. Taking the debate away from the share price was crucial for the ultimate success of the board’s defence; if all they had talked about was the offer price and Pfizer had then raised that offer price, they would have had little option but to recommend the bid. As it was, AstraZeneca today remains an independent company which continues to invest in high-skilled R&D work in the UK.

Not all takeover bids concern companies as research and skills intensive or as high profile as AstraZeneca and, as already noted, the TUC continues to believe that reform of mergers and takeovers is necessary. Nonetheless, the contrast between these two bids suggests that the relatively subtle reform of the Takeover Code in 2012 has made a genuine impact on practice, at least in this case.

4. Conclusion

The Kay Review’s analysis is excellent. It sets out what the core purposes of equity markets should be; describes clearly the complexity and conflicts of interest that hamper the investment chain; and makes a compelling argument that dysfunctionalities within capital markets are damaging both savers and the real economy.

However, the TUC believes that the Review’s recommendations are not sufficiently strong to address the extent of the problems it so clearly
outlines. Too much faith is placed in what are essentially voluntary measures, while few concrete mandatory measures are proposed by the Review. The TUC’s experience over the last decade of campaigning for asset managers to disclose their voting records shows that much of the industry is very reluctant to change its behaviour unless forced to do so.

The Review argues that the problem with the interaction between shareholders and companies is damaging company performance in the UK, which chimes absolutely with the TUC’s own analysis. However, the TUC concludes from this that fundamental reform of the UK’s corporate governance system, and the reliance on shareholder engagement within it, is necessary and urgent. We would like to see directors’ duties re-written so that directors are required to promote the long-term success of the company as their primary duty, with the promotion of shareholder interests secondary to this central aim. The TUC has also called for the introduction of stakeholder participation in corporate governance and for the representation of workers on company boards. In other words, we would like to reform the role of shareholders within the UK’s corporate governance system and remove the priority given to their interests. While these proposals go beyond the scope of the Kay Review and were never on its agenda, there is nonetheless a gap between the stark picture painted by the Review and the recommendations it proposes. The TUC remains sceptical about whether the Review’s proposed reforms will be sufficient to overcome the difficulties caused by the fragmentation of shareholdings, excessive intermediation and a reliance on trading strategies it so eloquently sets out.

Take, for example, the barriers to engagement created by the highly diversified holdings of most asset managers. The Review clearly sets out the problem; to address it, it includes a direction to asset managers: ‘Active asset managers should typically have more concentrated portfolios which are more differentiated from each other and from benchmark indices, and regulatory discouragements to such behaviour should be reduced or removed’. The problem is that simply stating what should happen is by no means sufficient to bring this change about. Unless the ‘need’ of asset managers to hold diversified portfolios to protect themselves against risk is addressed, they will continue to hold large portfolios.

5. See e.g. Williamson (2012) and TUC (2013).
A gap in the Kay Review is the role of asset owners, about whom there is relatively little discussion. This is disappointing, as some investigation of how requirements for pension scheme funding may contribute to short-termism in equity markets would have been useful. Defined-benefit pension schemes in the UK are required to carry out valuations every three years based on mark-to-market accounting and to set out plans to address any deficits. This means that trustees have to focus on value creation over relatively short timescales, which may sometimes take their attention away from long-term performance. The TUC raised this in its submission to the Kay Review (TUC 2011). It is a difficult area to address, as clearly funding requirements for pension schemes exist for very good reasons; but it is disappointing that these issues were not picked up by the Review. Another issue that would have benefited from inclusion in the Review is the tax relief on interest payments on corporate debt. There is increasing recognition that this has distorted markets by encouraging investment to take the form of debt rather than equity and there have been widespread calls for its abolition. Despite this, the issue was not covered in the Review.

To conclude, the strength of the Kay Review is undoubtedly its analysis—the accurate description of the practice of equity markets and correctly ascribing this to the incentives and structure of the market. This has had a lasting impact on the terms of debate around equity markets and short-termism in the UK. The Review’s weakness is its recommendations, which rely too much on normative statements and voluntary measures to address sufficiently the problems it sets out. But perhaps we need to make judgement over the longer-term; it is not possible to redesign equity markets overnight and the Review may have an impact in the medium or long-term through influencing the direction of future regulation and incentives. But there is also a danger that it slips too easily beneath the water, leaving ripples that still too quickly to disturb the supertanker of dysfunctionality it was designed to overturn.
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Appendix: Kay Review Principles and Recommendations

Principles

1. All participants in the equity investment chain should act according to the principles of stewardship, based on respect for those whose funds are invested or managed, and trust in those by whom the funds are invested or managed.

2. Relationships based on trust and respect are everywhere more effective than trading transactions between anonymous agents in promoting high performance of companies and securing good returns to savers taken as a whole.

3. Asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest.

4. Directors are stewards of the assets and operations of their business. The duties of company directors are to the company, not its share price, and companies should aim to develop relationships with investors, rather than with ‘the market’.

5. All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client’s interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable.
and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.

6. At each stage of the equity investment chain, reporting of performance should be clear, relevant, timely, related closely to the needs of users and directed to the creation of long-term value in the companies in which savers’ funds are invested.

7. Metrics and models used in the equity investment chain should give information directly relevant to the creation of long-term value in companies and good risk adjusted long-term returns to savers.

8. Risk in the equity investment chain is the failure of companies to meet the reasonable expectations of their stakeholders or the failure of investments to meet the reasonable expectations of savers. Risk is not short-term volatility of return, or tracking error relative to an index benchmark, and the use of measures and models which rely on such metrics should be discouraged.

9. Market incentives should enable and encourage companies, savers and intermediaries to adopt investment approaches which achieve long-term returns by supporting and challenging corporate decisions in pursuit of long-term value.

10. The regulatory framework should enable and encourage companies, savers and intermediaries to adopt such investment approaches.

Recommendations

1. The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.

2. Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review’s Good Practice Statements.
3. An investors’ forum should be established to facilitate collective engagement by investors in UK companies.

4. The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.

5. Companies should consult their major long-term investors over major board appointments.

6. Companies should seek to disengage from the process of managing short term earnings expectations and announcements.

7. Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.

8. Asset managers should make full disclosure of all costs, including actual or estimated transaction costs, and performance fees charged to the fund.

9. The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.

10. All income from stock lending should be disclosed and rebated to investors.

11. Mandatory IMS (quarterly reporting) obligations should be removed.

12. High quality, succinct narrative reporting should be strongly encouraged.

13. The Government and relevant regulators should commission an independent review of metrics and models employed in the investment chain to highlight their uses and limitations.
14. Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.

15. Companies should structure directors’ remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.

16. Asset management firms should similarly structure managers’ remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.

17. The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.

Source: Kay (2012)
Chapter 3
Long-term orientation and sustainability through financial transaction taxes

Andreas Botsch

It is almost certain that there is some level of trading activity that is not economically optimal, beyond what is optimal, and if we impose on that a relatively small tax we can be confident that at very least we will gather some money in way that is not harmful; because even if it somewhat reduces the trading activity, if we believed the trading activity was too much in the first place then we have not done harm (Lord Adair Turner, Chairman of the UK Financial Services Authority).¹

1. Financial transaction taxes - geographic scope and legislative basis

This chapter analyses the rationale and current state of play for the introduction of financial transaction taxes (FTT) in Europe. FTT, which impose a small tax on financial transactions of specific kinds, are significant for a number of reasons. First, the introduction of FTT at least at EU level constitutes one of the cornerstones of the trade union agenda for financial market reform (Botsch 2011). Second, although the proposed FTT appears to be low (according to the Commission’s 2013 proposal 0.1 per cent for securities and 0.01 per cent for derivate products) this would nevertheless significantly cut into the profits of speculative trading strategies and thus help redirect investment away from the short term. As such it is a significant policy measure that, together with other instruments, could help support the Sustainable Company.


This followed the decision of the Council on 22 January 2013 to authorise enhanced cooperation between 11 Member States representing 2/3 of EU GDP (France, Germany, Belgium, Austria, Slovenia, Portugal, Greece, Slovakia, Italy, Spain and Estonia) and the consent of the European Parliament given on 12 December 2012.

For the first time since the Treaty of Lisbon entered into force on 1 December 2009, the European Union legislator has invoked the legal basis for enhanced cooperation among certain member states (article 20 of the Treaty on European Union, TEU and articles 326-334 of the Treaty on the Functioning of the European Union, TFEU) who declared themselves willing to introduce a comprehensive system of FTTs. The February 2013 proposal was preceded by a series of legal examinations, which included verification that the enhanced cooperation procedure (ECP) initiative is non-exclusive and open to all (at that time) 27 member states, that it does not fall under exclusive competence of the Commission and that it is not detrimental to the principles of the Internal Market. According to the draft Directive, all transactions except currency transactions would be subject to FTT, at a rate of 0.1 per cent for securities (shares, bonds) and at 0.01 per cent for derivative products.

A previous proposal of the Commission from September 2011 (EC 2011a) was based on articles 113 and 115 of the TFEU, arguing that taxation of the financial sector needed coordinated action at EU level to create a level playing field and to avoid fragmentation of the EU financial market and distortion of competition (EC 2011b). This had given rise to nine months of intense debate in the Council and the European Parliament, which resulted in the Danish presidency’s conclusion in June 2012 that an EU-wide system of FTT could not be supported by all 27 member states. Invoking the Lisbon Treaty’s Enhanced Cooperation Procedure has therefore become the last resort for a ‘coalition of the willing’ to proceed with FTT. Eleven member countries subsequently expressed their wish to proceed to ECP and submitted a formal request to the European Commission, specifying the scope and objectives of an ECP on FTT. In contrast to the ordinary legal procedure on taxation which requires unanimity, the decision by the Council was taken by qualified majority voting to allow ECP to go ahead. Unanimity is required only among those countries who wish to participate.

The Commission has proposed that a portion of the revenue could be used as an own resource for the EU budget, whereby the ensuing reduction of
the national contributions of participating Member States could be used to help consolidate public finances, contribute to public investment or finance official development aid budgets. However, in a strictly legal sense, no earmarking of FTT revenue is foreseen so that participating Member States are free to decide how the revenues of the FTT should be used.

A comprehensive FTT levied by less than 27 EU member states requires effective built-in safeguards against tax evasion. These would ensure the tax to be levied on the basis of the EU residence of the counterparty of the transaction, combined with issuance and ownership principles to make sure the tax is paid as a pre-condition to legally enforce the transfer of ownership. Compared with the original FTT proposal of the Commission from September 2011, the new proposal enhances the safety net against potential relocation of financial sector activity outside the jurisdiction. On top of the ‘residence principle’, meaning that FTT will be due if any party to the transaction is established in a participating Member State, the proposal has added the ‘issuance principle’. The issuance principle provides for tax collection even when both counterparties are outside the scope of the law but the traded securities originate from within. This means that financial instruments issued in the 11 Member States will be taxed when traded, even if those trading them are not established within the FTT zone, e.g. French securities traded on the London Stock Exchange. For any future EU legislation on taxation, it is significant that the Commission for the first time has accepted the principle of an exterritorial application of taxes when it comes to prevent unfair tax competition and to create a level playing field within the Single Market.

A report by the European Parliament, while not legally binding, has further enhanced the legislative proposals made by the Commission, by including currency transactions on foreign exchange (FX) spot markets (EP 2013). On the other hand, growing pressure by the financial industry on conservatives and liberals in the EP has achieved recommendations for the introduction of several exemptions in the Directive. Among these are exclusions from the FTT for inter-group transactions and market-making transactions purportedly meant to provide liquidity, and also the introduction of special rules for pension funds. For a transitional period of three years, up until 2017, the rate for pension funds’ transactions on shares and bonds will be halved (limited to 0.05 per cent), as well as the rate for derivatives transactions (limited to 0.005 per cent). Similar rules
would apply to transactions on sovereign bonds on secondary markets (rate of 0.05 per cent until 1 January 2017), while a tax rate of only 0.01 per cent would be levied on short-term repurchase agreements of duration of up to three months. With the latter, the inter-bank lending market has in fact gained a tax exemption of 90 per cent.

With the exception of the latter, these exemptions do not go too far in diluting the original proposals. However it has rightly been observed that exclusions and exemptions of any type can be exploited to the detriment of the tax’s effectiveness (Gray et al. 2012). This judgement is broadly in line with demands from trade unions and civil society organizations across Europe, including a long-standing demand of the ETUC itself, for a comprehensive system of FTTs at a single tax rate of 0.05 per cent, levied on all transactions of shares, derivatives, currency units and bonds; furthermore, no exemptions should be made for any of the aforementioned, except for the primary issuance of government and corporate bonds and shares. In addition to the residence and the issuance principle, civil society organizations have demanded the application of the ownership (or exchange of legal title) principle, which would follow the example of stamp duties, i.e. a transaction would be legally valid only upon payment of the tax (ETUC 2011; Botsch 2012).

From 2013 to date (August 2015), negotiations among the ‘coalition of the willing’ have focussed on possible exemptions from the FTT as well as its tax base. France, Italy and Spain have sought to limit the burden on the financial sector in general, while the highly indebted countries in Southern Europe are aiming at a FTT break for their sovereign bonds. Technical talks on what assets to tax, which to exclude, means of tax capture etc. were locked in stalemate until the beginning of 2015, when the government of Austria, the strongest supporter of a broad-based FTT, took over the political coordination. At the time of writing, the most likely outcome of the enhanced cooperation procedure should be as follows: FTT should be implemented progressively starting early 2016, with taxation of transactions in shares and some of the derivatives being the first step, while other steps are to be taken after the completion of a forthcoming economic impact analysis. Member States that would like to impose taxation for other products that are not included from the beginning of a progressive implementation would be allowed to do so in order to maintain existing taxes. Both residence and issuance principles should apply, but cumulating the two principles may eventually apply to the EU-11 shares only. Revenue from FTT is however likely to be
significantly lower than expected, since some countries are aiming at limiting taxation of intra-day trading to the net balance at the end of the trading day. Such a move would de facto drop one of the main rationales behind FTT by exempting high frequency trading from being effectively taxed. Other potential exemptions from the original Commission proposal concern the transactions of non-listed company shares, interest rate swaps and the valuation of the tax base for derivative products (notional vs. synthetic market value).

The first half of 2015 was over-shadowed by the Greek crisis. An agreement on the ‘core engine’ of the FTT was therefore postponed and should be expected during the second half of the year. Tax rates will be the last ‘building block’ element to be discussed. A political agreement by December 2015 is to be followed by drafting the text and adopting the final directive by the end of the Dutch Presidency (June 2016). The subsequent implementation procedures of the Directive through national parliaments would likely set the generation of first revenues to early 2018.

2. The different rationales behind FTT

Taxing financial transactions in individual European countries is not a novelty nor is the idea of international financial taxation new. The principle of taxing financial market flows was for the first time recognised in 1694, when Great Britain introduced a stamp duty at the London Stock Exchange on securities transactions. The tax is payable by the buyer of shares for the official stamp on the legal document needed to formalise the purchase of the security. It is the oldest tax still in existence in the UK. It provides billions of pounds’ worth of stable revenue (USD 5.86 billion in 2008) and today’s tax rate stands at 0.5 per cent. The fact that 33 countries (eight of which are European) are currently applying some form of FTT on various instruments, ranging from stocks and both corporate and government bonds to foreign currency exchange and foreign capital inflows,2 is a clear indicator that the dangers of relocation are rather limited. In 14 countries, the annual revenue raised exceeds USD one billion, and total annual revenue is more than USD 51 billion for those countries where FTT tax revenues are available (Stamp Out Poverty 2012: 11).

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2. See the list of countries and different tax instruments in Stamp Out Poverty (2012: 9-11).
Following the Great Depression in the 1930’s, Keynes wrote in his General Theory of Employment Investment and Money: ‘The introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise (…)’ (Keynes 1936: 104). After the collapse of the Bretton Woods system of fixed exchange rates in 1972, James Tobin elaborated Keynes’ idea further when he proposed an international currency transactions tax as ‘a quite innocuous way, to throw some sand in the wheels of super-efficient financial vehicles. A half percent tax translates into an annual rate of four percent on a three months’ round trip into a foreign money market, more for shorter round trips. It is this effect that creates room for differences in domestic interest rates, allowing national monetary policies to respond to domestic macroeconomic needs. The same tax would be a smaller deterrent to slower round trips. It would be a negligible consideration in long-term portfolio or direct investments in other economies. It would be too small, relative to ordinary commercial and transportation costs, to have much effect on commodity trade.’

While the two classic rationales (Keynes 1936: Chapter 12; Tobin 1978) focussed on FTT as a regulatory means to keep irrational exuberance of financial markets in check and to ensure policy dominance over markets, the United Nations Development Programme UNDP in the 1990’s advocated a ‘Tobin Tax’ whose revenues could finance a global North-South pact for development administered by the United Nations (see ul Haq et al. 1995), a proposal that James Tobin in turn distanced himself from (Tobin 1996: 63). Our view here is that earmarking of tax revenue is of secondary order to levying it in the first place.

3. **Scope and regulatory purpose today**

The international and European trade union movement formulated its demands for an international tax on foreign exchange transactions in the aftermath of the Mexican peso crisis in 1995, in combination with a demand for more stable parities between the currencies of the European Union, the Japanese Yen and the US Dollar to:

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...replace the monetary chaos of the present situation with order. (...) The benefits of these initiatives would far outweigh the massive costs of policy inertia. Financial markets would still operate autonomously, but financial flows would be directed towards beneficial long-term investment and not short-term speculation; currency market volatility would be reduced, thus allowing traders in goods to plan ahead and obviate the need for hedging; and the degree of autonomy for government policy making would be expanded.4

Since 2009, the ETUC, its affiliated trade union organisations and civil society organisations across the EU have intensified their campaign for a broad based FTT that would generate significant revenues for public goods, e.g. to create jobs and growth, while also contributing to better regulation of European financial markets. FTT has been at the heart of the campaign ‘Europeans for Financial Reform’5 with six broad themes: (1) new rules for the financial system, (2) restoring publicly accountable authority over global finances, (3) controlling executive and shareholders remuneration and decent salaries for workers, (4) protecting public finances, (5) protecting consumers against toxic financial products and (6) bringing banks back to basics.

Since the turn of the century the volume of financial transactions has exploded. Financial ‘innovation’ brought about new products, turnover increased and holding periods for financial instruments decreased dramatically. In addition, transaction costs saw a sharp decline to about one tenth of where they were throughout the 1980s (Matheson 2011). Today, global foreign exchange market turnover among the ten most important currencies makes up more than 90 per cent of the currency trades with a volume traded of USD 5300 billion daily (BIS 2013). Flexible exchange rates and deregulated financial markets have fuelled a huge increase in speculation and market uncertainty. The global flexible exchange rate system constitutes one of the most important factors behind the growing instability of the world economy (Payandeh 2011). The absence of a new global currency system with a built-in mechanism for adjusting exchange rates implies that James Tobin’s ‘sand in the

wheels’ argument is still valid - although Tobin himself had never imagined the devastating character of derivatives and excluded them from his tax proposal. At the time of his proposal, derivatives were primarily used for legitimate hedging against exchange rate risks rather than speculation. Today the situation is different. The notional amounts of outstanding OTC derivatives in 2011 were USD 700 trillion and exceeded global GNP by more than 1100 per cent. Since 2000, the amount has increased sevenfold. An FTT would seriously affect the attractiveness of market entry of those instruments and thus contribute to crisis prevention. Briefly and succinctly, transactions of both spot and derivative assets must be taxed to capture the speculative nature of financially ‘innovative’ products.

According to the latest Bank for International Settlements’ Triennial Central Bank Survey (BIS 2014), trading in global foreign exchange markets (FX) averaged USD 5.3 trillion per day in April 2013. This compares to 3.98 trillion in April 2010 and 3.3 trillion in April 2007. Foreign exchange swaps were the most actively traded instruments in April 2013, at USD 2.2 trillion per day, followed by spot trading at USD 2.0 trillion. Annual transactions amounted to USD 1405 trillion, exceeding world output 18 times and world trade more than 40 times. In 2011, less than four per cent of financial market turnover was needed for world trade in goods and (non-financial) services, and even if one allows for amply hedging against currency and interest risks of real trade, still more than 90 per cent of financial market turnover can be regarded as ‘hot air’ or speculation. The Commission’s argument that levying currency transactions would constitute an undue restriction of European freedom of capital movements can be easily refuted. The general interest in stabilising financial markets by reducing speculative trading and its compatibility with WTO rules has been well established. It is therefore welcome that the EP has broadened the tax base compared to the Commission proposal to include foreign exchange currency transactions.

It is often argued, not least by the financial sector, that FTT would reduce liquidity in the markets, raise capital costs and thus, by raising obstacles to market efficiency, be detrimental to growth and ultimately employment. This must be questioned seriously. Liquidity as such is not

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7. See the discussion in European Commission (2011b).
a value in itself; it depends to which purpose financial market liquidity is being used, for diversity of investments or for betting following herd instincts. In his famous chapter on the state of long-term expectations, Keynes wrote in his General Theory:

Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of 'liquid' securities. It forgets that there is no such thing as liquidity of investment for the community as a whole. The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of the most skilled investment to-day is 'to beat the gun', as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow (Keynes 1936: 102).

Much of the overheating of financial markets is due to a continuous decline in holding periods for financial instruments from an average of seven years to only seven months over the past 40 years (Schäfer 2012). High speed data transmission technologies have made High Frequency Trading (HFT) possible, a form of computerised trading driven by algorithms. It is the 'herd instinct' of machines and trend following, so that computers are buyers when markets are rising and sellers when markets are falling, which, as Griffith-Jones and Persaud have argued, reduces diversity and saps liquidity (Griffith-Jones and Persaud 2012: 9). Very likely to be most affected by FITT will be those engaged in high-frequency trading. This concerns a relatively small number of firms that nevertheless command up to 75 per cent of market share.8 Affecting HFT by FITT is deliberate, since FITT intends to have distortive effects if it is to correct a situation that one wishes to change. The IMF in its assessment to the G-20 stated in 2010: ‘The impact on financial markets from a low-rate (less than 5 basis points), broad-based STT [securities transaction tax] would likely be fairly modest, beyond its reduction of very short-term trading’ (IMF 2010: 177).

The burst bubble and the ensuing financial crisis in many countries have led to balance sheet recessions (Koo 2012). Private as well as public sector

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8. Computer-led Exchange Traded Funds (ETF) have lately generated higher stock market turnover than individual stock trading (FT 7 August, 2012).
debt has attained unsustainable highs, forcing economic agents, households, enterprises and public budgets alike, into synchronous deleveraging. The ensuing contraction of debt markets will make it more and more difficult for the asset surplus of creditors to find attractive investment opportunities for their net savings. This constitutes a macro-economic problem that proponents of supply-side economics are largely ignoring. A real risk consists in these assets remaining in the financial sphere, as long as the size and speed of financial markets continue to expand. FTTs should therefore help reduce the massive liquidity overhang in markets and remove those superfluous transactions, which are neither of social use nor serve an economic purpose. FTT will steer financial flows towards the long-term and thus help restore the fundamental economic role of the financial system of intermediation, allocation and transfer of capital to productive use: finance must serve the real economy not vice versa. Far from being a panacea, FTT still constitutes an essential element of a financial reform agenda that intends to achieve stable and cost-effective financing for the real economy, to stabilise macro-economic volatility and allocate finance to socially beneficial use.9

4. Tax revenues

Democracy and social justice are at risk if workers and their families are to bear the lion share of the financial crisis burden, the cost of which the Commission estimated to have reached € 4600 billion or 40 per cent of EU-27 GDP for bank bailouts (recapitalisation of financial institutions, guarantees on bank liabilities, relief of impaired assets and liquidity measures) by the second half of 2010 (EC 2011b), not taking account of the broader economic and social costs such as unemployment and output gaps. Output gaps from 2009-2011, i.e. effective lower GDP compared to potential output, amount to more than € 1400 billion or 12 per cent of potential wealth loss to the EU as a whole, resulting in a bill of the financial crisis to society exceeding 50 per cent of EU-27 GDP. It follows that democratic societies cannot accept that financial institutions expropriate public budgets with impunity because of perverse incentives for excessive risk taking or because of the prevailing moral hazard problem in financial markets. Taxing the hitherto under-taxed financial

9. See Botsch (2011) for more details.
sector has therefore come to the fore of the debate, not least because of the need to tap new and additional sources of revenue for heavily strained public budgets.

Both the IMF (2010) and the Commission have found that the financial sector is benefitting from direct and implicit tax subsidies. The Commission calculated the potential tax advantage of EU financial institutions from being VAT exempted ranging from €14 to 23 billion or 0.12 – 0.19 per cent of GDP per year. It concluded that there was a problem of preferential treatment of the financial sector compared with other sectors in the economy as well as a distortion in prices (European Commission 2010; European Commission 2011b: 4-5). In addition, large systemic ‘too big to fail’ banks are getting an implicit subsidy from government (bailout in the event of future failure), which translates into a funding subsidy on their wholesale funding since (private) creditors are willing to lend to them at a rate significantly lower than the rate at which they would be willing to lend to their competitors who do not enjoy an implicit guarantee from the State.

The bank bailouts in Europe plus the revenue aspect of FTT are also the main drivers of the huge popular support that the tax has gained over the past four years. In September 2011, over 65 per cent of European citizens were in favour (European Commission 2011c: 15) and millions of people have joined national campaigns for FTT. The FTT has gained economic credibility; it has received high level political backing from over 1000 economists and from leading figures such as Bill Gates and George Soros, who have pointed to the technical feasibility and the moral right of the tax.10 Thus FTT could help restore confidence in the financial sector that has been deeply shaken since the crisis, including in the eyes of a broader public.

Assuming that FTT would be levied on the basis of the residence, issuance and ownership principles altogether, potential revenue of FTT will depend both on the tax base and applied tax rate for different financial products. The European Parliament follows the Commission in supporting a rate of 0.1 per cent for securities (bonds and shares), excluding

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primary market operations (i.e. the issuance of securities), and a tax rate of 0.01 per cent on the notional value of derivative contracts. In the Commission proposal these are minimum tax rates that leave room for member states to levy higher ones. Moreover, FTT is to be paid by both buyer and seller, so that if one counter-party resides outside the territorial scope of the Directive, the other counterparty is liable to pay the whole sum. This model of differentiated tax rates bears some problems though. The notional value of many derivative contracts is not denominated in Euro or other currency value, but can be index linked or hidden in other financial instruments such as index options or convertible loans. The most toxic assets in the US housing bubbles were highly complex multi-layered derivative products that only the designers of the contracts (if anyone) could understand. The notional value of these derivative contracts that serves as the tax rate in the EC and EP model appears difficult if not impossible to determine (Sieling 2012: 3). Since the risk of abuse is considerably high, a uniform tax rate of 0.05 per cent on all transactions would delimitate tax evasion effectively. Admittedly, it would increase the cost for risk prevention measures such as (legitimate) hedging, but, as has been argued above, hedging makes up only a tiny fraction of the global derivative market.

Applying the differentiated rates at EU-27 level, the Commission estimates total revenue of € 57 billion (EC 2011b), two thirds of which is levied at 0.01 per cent on either equity, currency or interest rate linked derivative contracts (37.7 billion), the other third (19.4 billion) levied at 0.1 per cent on securities. It should be noted though that the Commission proposal excludes currency transactions from FTT. But even then, a uniform tax rate of 0.05 per cent on transactions taxed after the Commission model could yield more than three times as much, namely almost € 200 billion for the whole EU.

In 2010, Schulmeister calculated FTT revenue based on scenarios with the assumption that transaction volumes will be reduced following the introduction of FTT (Schulmeister 2010: 47). In a medium ‘transactions-reduction-scenario’ trading volumes would decline by roughly 75 per cent at a tax rate of 0.1 per cent, by 65 per cent at a rate of 0.05 per cent and by 25 per cent at a rate of 0.01 per cent. The rationale for these assumptions makes sense since the intended regulatory effects of FTT are declining volumes of transactions that are shrinking the tax base and subsequently leading to falling tax revenues. Once these effects are occurring sensibly, the introduction of a Financial Activities Tax as
suggested by the IMF (IMF 2010) should be considered in parallel to the FTT to keep revenue at a stable level. According to Schulmeister’s calculations, initial FTT revenue for the EU-27 at our preferred tax rate of 0.05 per cent on all spot and derivatives transactions on and off exchanges (OTC) would amount to € 235 billion or 1.8 per cent of EU GDP (Schulmeister 2012: 88).

Schäfer and Karl from the German Institute for Economic Research DIW in a study published June 2012 calculated much higher revenues from FTT than forecasted by the Commission (Schäfer and Karl 2012: 17). According to them, the impact assessment of the EU Commission systematically underestimates the revenues of the FTT. Given the differentiated tax rate model of 0.1 per cent and 0.01 per cent as suggested by the EC, and assuming FTT would reduce the taxable base of securities trades by 15 per cent and that of derivatives by 75 per cent, total tax revenue would amount to € 37.44 billion for the nine countries alone that have declared to embark on an ECP procedure. Under the same assumptions of FTT effectiveness, a uniform tax rate of 0.05 per cent would yield more than € 89 billion for the nine countries in question (Schäfer and Karl 2012: 31). In case that derivative markets would shrink heavily by 90 per cent, revenue would still amount to more than € 40 billion. The same study identifies two beneficial macro-prudential regulatory effects of an FTT which have not been highlighted by most other authors so far: the practice of issuing credit default swaps would be significantly reduced as would be the interconnectedness of financial institutions.

In 2013, Schulmeister and Sokoll updated their calculations, using the EC tax rates and focusing on the application of the residence principle first for the 11 participating ECP countries only, and for the EU27 as a whole (Schulmeister and Sokoll 2013). In the case of ECP-11, they found that overall FTT revenue could amount to € 65.8 billion, more than estimated by the EC for the EU-27 as a whole, subject to London subsidiaries being treated as part of their parent company based in the ECP-11. However, if London subsidiaries were treated as British financial institutions, tax revenues would amount to only € 28.3 billion.

11. As of end July 2012, these include Austria, Belgium, Finland, France, Germany, Greece, Italy, Portugal and Spain. Others are likely to follow. The Netherlands for example could yield € 3.3 billion FTT revenue per annum.
A study commissioned by the German Ministry of Finance to Copenhagen Economics in 2014 (Næss-Schmidt et al. 2014) came to differentiated conclusions, estimating revenues for German governments alone at € 37.5 billion, and overall revenue at € 95.7 billion.

However, taking into account the negotiations among the ECP-11 since 2013, overall revenues are likely to be significantly lower than expected in the above mentioned studies. Countries have disagreed about the targeted revenue the tax should raise. While France has called for a phased-in approach that only covers a few types of trades at the start, Austria, Germany and others have said the tax needs to collect substantial revenue to be worthwhile. It is important to note that pre-funded pension systems have not figured among the items to be exempted from FTT.

To sum up, it appears difficult to discern the exact amounts of revenue of an FTT over time. When the FTTs show their intended regulatory effect as stated above, i.e. declining volumes of transactions leading to a contraction of the tax base and subsequently to falling tax revenues, the introduction of a Financial Activities Tax (FAT) as suggested by the IMF should be considered in parallel to the FTT. The question then arises how much revenue should and would a FAT yield that is introduced once the regulatory effects of FTT start to erode significantly their own tax base?

The IMF (2010) considered the possible use of a ‘financial activities tax’ (FAT) levied on the sum of financial institutions’ profits and remuneration, variously defined, for the purpose of raising revenue from the financial sector, while not ruling out the use of FTT for this and other purposes. According to the Commission, EU-27 revenue from a FAT would amount to anything between € 13.6 and 30.3 billion per annum (EC 2010), depending on the definition of the tax base. The major shortfall of FAT is that it can only be applied to banking and financial institutions, not to financial products being traded; therefore it is deemed proper to serve as a supplement not a substitute for FTT.

5. Effects on growth and income distribution

In the original impact assessment of its proposal, the Commission came up with an estimate of a total loss of 0.53 per cent GDP over the long run as a result of FTT (EC 2011b). The May 2012 update of the model used gave a far lower estimate for the impact of an FTT on the level of
economic growth, equal to only 0.2 per cent GDP. However, the Commission estimates are based on a model that even in its revised form is incomplete and excludes some of the crucial positive impacts such as the reduction of systemic risk (thus the probability of further crises), the expansion of total aggregate demand for consumption, and the boost of the European real economy through fiscal consolidation. The positive effects not considered by the Commission are likely to more than compensate the negative effects. Therefore, the impact of FTT on economic growth is likely to be positive, at 0.25 per cent GDP as a minimum (see Griffith-Jones and Persaud 2012). Griffith-Jones and Persaud suggest in their analysis that the overall positive impact on growth could be even higher, for which they identify a number of different channels of fiscal redistribution, while highlighting the progressive nature of the tax.

The latter findings are confirmed by Schäfer and Karl, who point to the fact that lower income households in most cases have no income from financial assets, showing that in the French case the lower 19 twentieths of households yield merely 1.6 per cent of their income from financial assets (Schäffer and Karl 2012: 39). Since the distribution of assets (capital) in society is significantly more unequal than the distribution of income, the tax incidence is clearly socially progressive and is unlikely to affect the majority of the population in any tangible way.

Negative externalities from FTT are furthermore unlikely since most transactions in the foreign exchange markets are conducted between banks themselves or with other large players in the financial services industry. Transactions with individuals constitute less than 0.1 per cent of total transactions and trade-related transactions amount to less than five per cent (see above). A significant proportion of the tax burden is thus likely to be borne by the financial services industry itself, with a tiny fraction of the costs being passed on to trade related transactions. The final tax incidence will depend on the extent to which financial institutions can pass on the tax. This, in turn, depends on the extent of competition in different segments of the financial sector. Imperfect competition in finance would make the case for competition policies to intervene, rather than constitute an argument against FTT.
6. The battle for exemptions

Anything that might hurt the privileged, such as higher tax rates or financial regulation, can be denounced as job-killing because it undermines confidence (Paul Krugman).12

Almost immediately after the European Commission adopted its first proposal in 2011, an unofficial, yet very well organised campaign of financial institutions started against the FTT (Schulmeister and Sokoll 2013: 20). Fiduciaries and asset managers of pension funds have pursued the aim to achieve tax exemptions for their business models, counting heavily on the ‘fear factor’ to intimidate both future and current generations of pensioners and policy makers in charge. Financial institutions such as BNP Paribas, Deutsche Bank, Goldman Sachs, Citigroup, Bank of America / Merrill Lynch, or Morgan Stanley have sought to show various detrimental effects of an EU-FTT on banks and the economy as a whole, with varying degrees of internal contradictions and methodological flaws. Institutions that are heavily engaged in short-term and/or high-frequency trading are at least aiming at exempting exchange traded derivatives, which constitute the most important vehicles of short-term speculation; others have focused on exempting the short-term inter-bank lending market while institutional market makers have warned against liquidity shortages if they are not exempted from FTT. Their common objective is to deter policy makers in governments from introducing FTT altogether, and for that purpose a number of ‘studies’ have been commissioned which are all using large arsenals of intimidation.13

For illustrative purposes, Schulmeister and Sokoll have analysed a study by Goldman Sachs Equity Research14 which asserts a quasi-collapse of the inter-bank lending market (REPO) as a consequence of FTT. They conclude:

13. An impressive list of ‘anti-FTT’ studies commissioned by various vested interests can be found at https://secure.wiwo.de/finanzen/boerse/aktieninstitut-milliardenlasten-durch-finanztransaktionsssteuer-/8514988.html. Not surprisingly, stock exchanges also figure among the sponsors.
If banks were focused on financing activities in the real economy like real investment, production and trade of enterprises as well as housing and durables of private households, there would be no need to shortly raise millions or even billions through overnight REPOS. It is one objective of a FTT to change the incentive conditions in favour of real world activities at the expense of the profitability of ‘finance alchemy’ (Schulmeister and Sokoll 2013: 23).

Equally for exemplary purpose, we will focus here on the wide-spread assertion that FTT would effectively act as a tax on pensioners. The battle for exempting pension funds is a showcase for disguised short-term financial interests and for how FTT can act to re-orient markets toward more sustainability.

Following heavy pressure from alternative investment fund managers, asset managers of big pension funds and not least from MEPs adhering to the Alliance of Liberals and Democrats (ALDE) and European People’s Party (EPP) groups in the European Parliament, the EP at its May 2012 plenary session voted for the exclusion of pension funds from FTT (EP 2012). We consider this a political blunder, since the arguments of financial pressure groups for excluding pension funds are highly questionable and fundamentally flawed. Even the Commission in its updated impact assessment of May 2012 did not go so far as to kowtow to hidden vested interests that declare themselves effectually to speak on behalf of the general interest. Exemplary for this has been a Memorandum on the Costs of Financial Transaction Taxes (FTT) for Pensioners from the largest pension fund in the Netherlands that was floated in the aftermath of the publication of the Commission proposal. The APG memorandum concluded that ‘...FTT would hit ordinary pension savers very hard and would result in pensioners paying for the FTT through reductions in the value of their pensions. Pension savers and investors could end up shouldering an unfair share of the burden of the FTT. As proposed [by the European Commission], this would be a tax on current and future retirees and on savers’.15 This received echo by a number of politicians and academics who called FTT a ‘big tax on pensioners’, however it also completely ignores the debate about what the (socially useful) role of pension funds is.

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15. APG Memorandum, 31 October 2011, Amsterdam, http://www.apg.nl
The impact of FTT on pension funds depends firstly on the allocation of assets in portfolios, secondly on the frequency of trading of those assets and thirdly on the number of financial intermediaries involved in the transactions of securities. First, not all assets are taxable, e.g. cash and deposits, but also investment in land and real estate and private funds. In most European countries, the asset ratio not subject to FTT is roughly 20 per cent (OECD 2011a). Second, the alleged high tax burden on savings can only occur when either the frequency of trading or, thirdly, the number of intermediaries is high, since the tax rate is comparably low. It follows that FTT is negative for pensioners only when fund management strategies are aggressive or when asset managers are getting frontloaded by hedge funds or other alternative investment funds. It is indeed high frequency traders who front run pension funds on large orders. The FTT would make this business less profitable and would save pension funds money that could more than compensate for the FTT paid. The relevant question here is whether it is in the interest of the average pension saver that his or her pension fund is employing an excessively active fund management style for more return at higher risk.

Della Croce, Stewart and Yermo in a recent study on long-term investment have shown that investment holding periods have fallen significantly mainly due to the growing market presence of institutional investors, and ‘even supposedly long-term investors such as pension funds end up having portfolio turnover much greater than originally intended’ (Della Croce et al. 2011: 7). Their figures show that average holding periods on the major exchanges vary between 8-18 months (except for NASDAQ with 4 months in 2010), which is equivalent to a turnover per annum of effectively 0.66 to 1.5. The figure that APG circulated and that has largely been quoted by opponents to FTT is that, on average, the cost of FTT for pension funds would amount to €500/year/head or saver. How does one get to these amounts?

Suppose that an individual pension savings portfolio consists of 1000 securities of €100 value each, with assets totalling €100,000. A ‘passive’ asset manager would trade 25 per cent of the portfolio once a year, while an ‘active’ management would yield a turnover of all assets twice a year. The trading frequency of securities in ‘actively’ managed portfolios is thus eight times higher than that of the ‘passive’ management. FTT of 0.05 per cent is due at both the moment of buying and selling of assets. The passively managed fund would be taxed at only €25/year or 0.025 per cent of total assets, while €200/year would be due by the active manager,
representing 0.2 per cent of total portfolio value. Moreover, it should be noted that annual operating costs and management fees of 1.2-2.4 per cent average six to twelve times FTT due, and that average net returns on savings (i.e. nominal returns minus administrative costs) reached 2.6 per cent in the period from 2008-2010 (OECD 2011b), a period characterised by historically low interest rates. The OECD findings also showed that conservative (or ‘passive’) investment portfolio strategies yielded higher returns than actively managed funds, since trading costs (e.g. fees and commissions) payable by the fund occur in line with the number of trades per year.

The negative effects of an aggressive trading frequency become even clearer when looking at the value of an asset portfolio of initially €100,000 over a period of 40 years. Given an FTT rate of 0.05 per cent, actively managed funds with high turnover would reduce total asset value by €5000 or approximately 12 times as much as a conservative fund.16 In any case, asset managers of pension savings portfolios should be legally obliged to substantiate FTT levied on each individual portfolio, so that the contributing savers can easily identify the strategies of their fund management.

Lastly, what matters for the determination of the frequency of trading and the incidence of FTT derived from it, is also the number of financial intermediaries involved in the transactions of securities. A number of opponents to FTT have argued that in even a very simple securities transaction, assuming a base rate of 0.1 per cent as proposed by the Commission, the effective tax rate could end up as high as 1 per cent; it is argued that the cumulative effect on a pension fund with annual expected return on investment of five per cent could be significant17, since a threefold turnover of a portfolio per year would dent 60 per cent of gross return with FTT of 0.1 per cent applied, leaving aside additional operating and management cost of the fund. The Deutsche Bank and others have made the following calculation for one securities transaction: the original vendor of the securities would pay 0.1 per cent tax, the broker as buyer 0.1 per cent and again 0.1 per cent as seller to the clearing member, the latter 0.1 per cent each in buying from the broker and selling to another clearing member through the central counter-party (non-taxable), the second clearing member again 0.1 per cent both as buyer from the first

17. See examples given in Deutsche Bank (2011: 7).
clearing member and as seller to another broker who ends up selling the securities to the pension fund. Taken everything together, such a hypothetical chain of financial intermediaries would indeed raise the effective tax rate to up to one per cent per securities traded. However since primary issuers and centralised counter-parties (clearing houses) are exempt from paying tax, a simple buyer-seller scheme would apply with potentially one intermediary in addition. A chain of seven intermediaries of which six are subject to (double) taxation is simply not conceivable. If this were reality, downsizing the chain of financial intermediaries who bite off chunks of workers’ savings for their old age pensions would have to be eliminated through regulation, even without FTT applied. In any case, rent seeking intermediaries will have to be kept in check to protect workers savings for social security purposes, and FTT would help achieve this.

Others have argued that every time a worker reallocated his pension fund, the pensions would be reduced by five per cent (Kaserer 2013). The reality is somewhat different though. Workers’ retirement income is not entirely financed by pension funds. Across Europe, low- and middle-income worker pensions rely primarily on pay-as-you-go, tax-financed or book reserve systems, all of which will remain unaffected by FTT. Yet in those countries where old-age security relies on pre-funded, capital market based systems, brokers and asset managers will take the bulk of the FTT, the cost of which will not automatically be transferred to pension funds, provided that there is competition in the marketplace and asset managers will want to keep their clients.

It is undeniable that FTT will have an impact on the portfolio composition of pension funds and their risk management policy. This is however intended. If and when pension funds under-invest in productive and longer-term capital such as infrastructure, green investments and SME finance and are excessively reliant on external asset managers’ short-termism, a transparent FTT would encourage pension funds to reduce their exposure to short-term trading and to increase pension money in long-term investments (Botsch and Habbard 2011). Furthermore, pay-as-you-go pension systems bear neither the risk of fiduciary fees or capital market volatility nor do they risk being taxed in addition to income tax.
7. Conclusion

This chapter has analysed the rationale for and current state of play regarding the introduction of Financial Transaction Taxes (FTT) at EU level. The rationale for FTT are threefold: first and foremost, the volume of speculative transactions on financial markets would be curbed and both the size and volatility of financial markets shrunk. Short-term betting would be gradually substituted by longer-term investment. An EU-FTT would re-establish a more commensurate role for finance in society and the economy, and the financial landscape would become smaller in size, slower in speed, and less short-term oriented. Secondly, levying an EU-FTT would generate significant revenues and make the financial sector assume a fair and substantial contribution to offset the cost of the financial crisis by paying partly for the burdens associated with government interventions to repair the banking system. Last but not least, an EU-FTT would downsize the chain of financial intermediaries who bite off chunks of workers’ savings for their old age pensions, at least in countries where pre-funded private pension systems play an important role.

As FTT would discourage short-term speculative strategies and support long-term investment it would represent an important measure in support of the Sustainable Company. Although there clearly is no ‘silver bullet’ in this respect, which means that a package of policy measures would been needed to address a wide variety of institutions in Europe, nevertheless FTT could in principle be one of the most effective single mechanisms for lengthening the time horizons of financial investors.

As of the writing of this chapter, despite intense opposition from much of the financial industry, the passage of a FTT at European level appears likely in the near future. This passage would represent a significant step in the direction of promoting longer-term sustainable investment and the Sustainable Company.
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Chapter 4
Shifting to the long-term: the road ahead

Pierre Habbard

1. Introduction

This chapter discusses the need for and strategies supporting a shift in the investment time horizons of institutional investors towards long-term sustainable investment. Pension funds are the primary focus; because, in principle, they should have long-term time horizons (as managers of retirement savings) and secondly, should have an interest in the exercise of workers’ voice in corporate governance in social and environmental matters. The potential contribution of pension funds to clean energy finance is explored as an illustration of the role pension funds could play in supporting long-term sustainable investments.

The need for institutional investors to adopt long-term investment strategies – including investment in infrastructure, clean energy and transport – has become a policy priority at the international level. A first question to address is what long-term investment means: what it is, or, alternatively what it is not. Ideally the definition should take both approaches on board: (i) the positive approach, which is ensuring that institutional investors effectively deliver ‘patient, productive and engaged capital’, but in a responsible way and, at the same time (ii) the negative approach, shifting away from short-termist and speculative behaviour. In practice however, the two approaches rarely coexist, which can lead to some investor schizophrenia.

A lot of attention is paid to the role of pension funds in this debate. Given their social purpose (i.e. financing workers’ rights to decent retirement) and their long-term liabilities, it would make sense for pension funds to embrace a long-term investment strategy. Climate change finance provides a good example of how pension funds’ potential could be unleashed. Our calculation suggests that – in a ‘blue sky’ world – pension funds could theoretically deliver some USD 300 billion per year in net contribution to climate change mitigation projects.
The reality is somewhat different. There are several challenges that would need to be addressed to unleash the potential of institutional investors to engage fully in long-term investment strategies. In the short term, the prolonged quantitative easing policy by central banks is negatively impacting institutional investors with long-term liabilities. The post-crisis financial reforms – as legitimate as they may be from a financial integrity and stability perspective – have had some unintended consequences as well. The problem of risk rating is also acute for financing long-term infrastructure in developing countries. Overall, policymakers need to distinguish between ‘productive’ risk (or ‘good’ risk) and ‘unproductive’ risk (or speculative risk) when setting or reviewing financial prudential norms.

There are many structural barriers as well: there is a lack of marketable products and of standardised reporting requirements, including environmental, social and governance impact, that meet long-term investment criteria. Importantly, asset owners should exercise strong leadership to hold asset managers to account, which they currently for the most part do not do. The multiplication of intermediaries along the investment chain is creating major complications for asset owners who wish to ensure proper accountability of how their funds are being invested. Finally, the level of concentration of the financial sector and the role taken by large financial conglomerates that are ‘too-big-to-fail’ may also create structural challenges to asset management accountability and hence to long-term investment strategies.

Assuming that all the above requirements for an effective policy and regulatory road to long-term investment would come into effect: would that still be a desirable outcome? Could the costs outweigh the benefits when it comes to the public purse and to public services? These are key questions.

2. **What it is, what it is not**

The need for institutional investors to adopt long-term investment (hereafter LTI) strategies and in particular to increase portfolio ‘exposure’ to infrastructure projects, including clean energy and transport, has become a central policy priority at the international level. At its meeting in St Petersburg on 5-6 September 2013 the G20 endorsed a work plan (OECD 2013a) as well as new High-Level Principles of Long-Term
Investment Financing by Institutional Investors (OECD 2013c). The Principles were drafted by the OECD and followed on extensive work by the OECD Secretariat (2011c; 2013c). In the run-up to the summit, the Financial Stability Board (FSB, the forum through which G20 commitments on financial reform are to be implemented) released a series of reports on the ‘financial regulatory factors affecting the availability of long-term financing’ (FSB 2013a; 2013b). Promoting long-term investment strategies is on the radar screen of other key forums such as the European Commission (EC 2013) (see here the contribution by Johnston and Morrow to this volume).

A first question to address is what LTI means. In what follows we suggest two approaches: a positive list (what it is) and a negative list approach (what it is not).

2.1 A positive list approach

The FSB defines LTI as any financial asset which has a maturity exceeding five years and is invested in the productive capacity of the economy (including infrastructure, software, R&D, housing, oil, gas and energy). The rationale of the FSB is that institutional investors (in contrast with banks) ‘will need to assume a greater role in this market’, given ‘strains on government budgets and the weakened banking system’ (FSB 2013a: 2). As such the LTI concept is treated as a response to a post-crisis structural shift from a bank-centred Continental European and Japanese intermediated model of financing of the economy (i.e. corporate loans) toward an Anglo-American style dis-intermediated market-centred system (i.e. corporate bonds).

The FSB definition links LTI to productive capacity of the economy – which is welcome – but it sets an arbitrary horizon for what long-term is (five years) and importantly, it sets that horizon from the perspective of the asset being traded, not the holding period by the investors. In the extreme, a share traded and held less than five minutes on the market could qualify according to the FSB definition, since equity a priori has an infinite perspective.

A more qualitative approach prevails at the OECD. It defines LTI as ‘patient, productive and engaged capital’, that is:
— patient capital allows investors to access illiquidity premia, lowers turnover, encourages less pro-cyclical investment strategies and therefore higher net investment rate of returns and greater financial stability;

— engaged capital encourages active voting policies, leading to better corporate governance;

— productive capital provides support for infrastructure development, green growth initiatives, SME finance etc., leading to sustainable growth (OECD 2013d).

The OECD definition is superior to the FSB definition. Like the FSB, the OECD links LTI to the real economy (‘productive capital’). However its concept of ‘patient capital’ is not defined by the maturity of the asset, but by the holding period of the investor (‘access illiquidity premia’). Importantly, it adds the ‘engaged capital’ as a central dimension of LTI, hence stressing the importance of governance and transparency along the ‘investment chain’ – from asset owners, to asset managers, down to the board of invested companies.

While the OECD definition is a welcome one, it does not elaborate further on the conditions for productive capital to lead to ‘sustainable growth’. In particular there is nothing that would suggest in the OECD approach that environmental, social and governance (ESG) criteria should be taken on board, and indeed mainstreamed in the investment policy of institutional investors and in the reporting framework of asset managers and of invested companies.

2.2 A negative list approach

An alternative approach consists in defining LTI by what it is not. According to this approach LTI is needed in response to the concerns around the externality costs of short-termist and/or speculative behaviour by financial players. LTI then is considered less as a pro-active solution – financing the real economy – and more as a re-active solution to the growing financialisation of the economy. This approach – and one that is much favoured by international labour groups (Epstein and Habbard 2011) – requires some acceptable definition of terms like ‘short termism’, ‘financial speculation’ and ‘financialisation’ which can indeed be challenging.
The concept of short-termism for instance is most often associated with executive remuneration policy that harms the long-run interest of the company, leading to corporate decisions that are led by immediate financial gains (short-term share price gains, excessive dividend policies, share buyback programmes, layoffs in profitable activities, ‘fascination’ of CEOs for takeovers, listings or LBOs) rather than by real economic objectives (such as increasing market share, technology and innovation). It is also strongly associated with Anglo-American forms of capitalism. In practice however it can take different forms country by country, and the idea that short-termism is fuelled only by Anglo-American shareholder value models might be simplistic and misleading. Continental European and Japanese financial and governance models have had their own limitations in ensuring that companies adopt long-term strategies, as evidenced by recurrent problems with related party transactions when the company’s assets are diverted to serve the interests of the controlling shareholder.

Ideally, LTI should be defined taking both approaches on board: (i) ensuring that institutional investors effectively deliver ‘patient, productive and engaged capital’ (as the OECD puts it), but in a responsible way (as civil society and labour groups would add) and at the same time, (ii) shift away from short-termist and speculative behaviour. In practice however, the two approaches rarely coexist, which can lead to some schizophrenia, such as a given institutional investor financing projects and infrastructure with a clear long-term sustainability goal and at, the other end of the portfolio, increasing exposure to hedge funds and high frequency trading. At intergovernmental level, words like speculation and short-termism are still not acceptable terms. To give a practical example, during the round of negotiations that took place at the OECD regarding the above mentioned OECD/G20 Principles, the last part of the sentence ‘taking a long-term view also allows investors to appraise and benefit from the fundamental value of their investments, rather than be guided by short-term speculation’ was deleted in the final version that was made public at the St Petersburg summit in September 2013.

2.3 The central role of pension funds

Institutional investors can be divided into two groups: asset owners (pension funds, insurance companies, sovereign wealth funds) and asset managers (asset management firms and bank asset management branches). In the discussion on LTI, it is important to focus on the role
of asset owners, because they are the ultimate owners of assets and because their liabilities are long-term by definition.

This is particularly true for pension funds, whose liabilities can span over 20-30 years (i.e. the time needed to accumulate capital to finance workers’ right to retirement). With over USD 30 trillion assets under management – of which 90 per cent are managed in developed economies – pension funds represent an important class of asset owners. Importantly, they have a social purpose, that of financing workers’ right to retirement, and most often they are established as part of a collective bargaining agreement and include member-nominated representatives on their board of directors. Given their social purpose, it would only make sense for pension funds to embrace fully both negative and positive list approaches to LTI, i.e. shifting away from short-term to long-term investments, mainstreaming responsible investment practices and increasing portfolio exposure to infrastructure and job creation projects.

The pension funds that are market leaders in engaging in LTI and responsible investment strategies are all established under sector-wide collective agreements between employers and trade unions, most often as (pro-worker) ‘defined benefit’ schemes. There are only a handful of defined contribution schemes (favoured by employer groups) in the top ranking of pension funds investing in infrastructure (OECD 2013a: 32). In the case of clean energy investment, pension leaders include Danish PensionDenmark, ATP, US CalPERS and CalSTRS, Dutch ABP and PGGM, Swedish APs and several industry funds in Australia. The decision in April 2012 by the South African Government Employees Pension Fund – another pension fund with strong union representation on its board – to invest R 1 billion in green bonds is another example hereof.

3. The case of clean energy finance

The case of pension fund investment in climate change-related assets provides a good example of how investors’ potential could be unleashed for LTI. Irrespective of its sustainability objective, the long-term horizon of climate change finance happens to match the liability profile of pension funds. In theory it fits very well with pension funds’ long-term strategy.

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In reality, however, pension funds’ exposure to climate change is limited today. Or rather the current share of pension fund investments in climate change financing is open to debate to the extent that it is largely dependent on how one defines such investment, both in terms of objective – increasing environmental ‘efficiency’, increasing renewable energy, reducing greenhouse gas (GHG) emissions – and of asset classes – listed equity, bonds and investment funds.

At one end of the spectrum, a strict definition of climate change projects would limit the scope to ‘clean’ (renewable) energy private equity infrastructure funds. Under that definition, the current contribution of pension funds is very marginal. The share of clean energy infrastructure in the largest pension funds (i.e. those that are the current leaders) is typically around 0.3 - 0.5 per cent of total portfolio. Access to precise data is problematic. Current pension regulation does not require pension funds to report asset allocation in a sufficiently detailed manner so as to identify the exact share of portfolio invested in infrastructure funds. At OECD level, these are lumped together with other alternative classes under the category ‘other’.

At the other end of the spectrum, a wide definition would include the ‘sustainability’ equity indices, such as the Dow Jones Sustainability Index, in which case the share of pension funds’ portfolio in climate change might be well above ten per cent. But not all sustainability indices are climate change specific. Some are, because they are based on a positive list approach in which selection is limited to companies specialised in clean energy technology. Other indices select companies above a threshold of revenues generated by clean energy activities (say 30 per cent). But many other indices – and the largest and most accessible one for investors in particular – have a process-based approach, looking at ‘best practices’, risk management, and reduction in GHG emissions. Large multinational oil companies – such as BP, Chevron and Total – feature prominently in these indices.

Green bonds stand in between private funds and equity indices in the range of climate change related assets and are the most promising source of investment from a pension fund perspective. The fixed-income asset class, to which listed bonds belong, constitutes the preferred asset of pension funds (and of their regulators). Like ‘traditional’ bonds, green bonds can be issued by a variety of institutions: private corporations, governments and international agencies, or financial institutions (when
the green bond takes the form of a structured product, such as a collateral debt obligation).

As shown in the Annex to this chapter and in the chart below, and based on previous trade union work (ITUC and TUAC 2012) and OECD research (Della Croce et al. 2011), it would be theoretically possible to raise pension funds’ investment in climate change-related assets to reach five per cent of their total portfolio in a three year period, thereby generating some USD 300 billion in annual flows in these three first years.

Figure 1  Theoretical projections of pension funds cumulative exposure to climate finance

Source: ITUC & TUAC (2012).

4. The road to long-term investment

The above estimates are broad and could be fine-tuned of course. They nevertheless give an indication of the potential contribution of pension funds to climate change financing – the demand side – in a ‘blue sky’ world in which there would be no barriers or restrictions to LTI on the supply side. The reality is somewhat different. There are several
challenges and barriers that would need to be addressed and overcome to ‘unleash’ the financial potential of institutional investors to engage fully in LTI strategies.

4.1 Overcoming the crisis and... the monetary policy response to the crisis

The first barrier, in the short term, is the current economic crisis. Pension funds have been hit hard by the 2008 market crash and the financial instability that followed. By the end of 2010, pension funds in OECD countries had recovered USD 3 trillion from the USD 3.4 trillion in market value that they lost in 2008. The three year average pension fund annual real (i.e. inflation adjusted) return over 2008-2010 has been -1.4 per cent across the OECD. More than five years into the crisis, many pension funds in the OECD are still struggling to meet minimum funding levels (i.e. having sufficient assets under management to match future pension liabilities). The top priority for pension fund managers is to regain funding sustainability. Such an objective does not necessarily conflict or compete with LTI. But the crisis still is a primary concern for the time being. Given the inherent risks associated with developing new investment products and strategies, pension managers might be reluctant to accept investing, or increasing exposure in any asset classes that may put at risk their current compliance with regulated funding rules to meet long-term liabilities.

The prolonged ‘quantitative easing’ programme by central banks is also having unintended consequences on institutional investors with long-term liabilities. Since long interest rates are normally higher than short-term rates, the low interest rate environment and the flattening of the interest rate yield curve is a good thing for banks because they are highly dependent on short-term funding. It is a bad one however for insurance companies and for pension funds which have no short-term liabilities and, in contrast to banks, are very sensitive to long-term rates. This sensitivity occurs not only on the asset side, because of returns on investment, but also on liability side, since the valuation of pension liabilities is inversely proportional to interest rates. Quantitative easing and the resulting low interest rate environment may then in turn push investors into a ‘search for yield’, increasing exposure to high return, high risk assets, including, as the OECD (Antolin et al. 2011) puts it, ‘gambling’ investment strategies. The ultimate dangers of investors desperately
looking for yield is the mispricing of risk and assets and the creation of another round of speculative bubbles, as happened in 2007-2008.

4.2 Policy and regulatory coherence

Barriers to LTI also relate to inconsistent policy frameworks. The most obvious case of lack of policy coherence is clean energy. As long as policymakers let fossil fuel subsidies co-exist with pro-active clean energy policy, there is little chance that investors will trust and have confidence in meaningful, stable and predictable prices on carbon emissions, and hence on the comparative financial returns of clean energy. Policy coherence in the broad sense would also require governments to ‘lead by example’ by influencing practices that via state ownership and public procurement programmes can help move toward LTI.

Policy coherence also extends to financial regulation. The post-crisis wave of financial reforms that started with the G20 summit in London in April 2009 – as legitimate as they may be from a financial integrity and stability perspective – may have had some unintended consequences on investors’ capacity to shift toward a stronger LTI strategy. The need to limit both risk taking behaviours and leverage levels in the financial sector – as aimed for, for good reason, by several financial reforms – could indeed hamper the capacity of institutional investors to re-allocate money to LTI-oriented assets. This is particularly true for pension funds. Because they aim at financing a social purpose – workers’ right to retirement – they cannot take excessive risks in the choice and design of their investment policy. Yet LTI projects such as infrastructure and climate change mitigation may entail a higher level of risk than comparable non-LTI, non-infrastructure or non-climate related investments. These risks result from the use of recent or unproven technologies, uncertainty and inconsistency of regulations and policies as well as cross-border investment risks.

Another example is given by the generalisation of mark-to-market accounting rules in the valuation of liabilities, gains and losses, in contrast with alternative methods that allow ‘smoothing’ over a given period and/or that reflect the underlying performance of assets and investments, rather than the market price on a given day. Mark-to-market has the merit of instant transparency and, by definition, can be subject to differing interpretation. But it may create volatility in the calculation of liabilities.
and assets on the balance sheet of investors – in particular of pension funds (Severinson and Yermo 2012). When combined with relatively short-term information from asset managers, mark-to-market accounting can make it difficult for institutional investor to focus on LTI.

The problem of risk rating is also acute for financing long-term infrastructure in developing countries. Many developing countries have no sovereign rating, despite the fact that the existence of such a rating is a pre-requisite for foreign investors. According to a report commissioned by the G20, in 2012 nearly 77 per cent of the 35 Low Income countries (mainly in Africa) and 55 per cent of the 56 Medium Income Countries are still not graded by any rating agency. While 75 per cent of the 52 Upper Income Countries are graded, just 37 per cent are rated ‘investment grade’ (Roland Berger 2012). The report further highlights the lack of financial information for private infrastructure projects, since grades are not required. As a result, potential private investors have been basing their risk assessment only on sovereign risk, even though some business sectors are independent from this sovereign risk. Lack of information and the ‘disconnect’ between sovereign risk captured by the financial markets and the effective ‘business risk’ in LICs and Lower MICs leads to lower levels of funding and higher costs of financing than would apply otherwise.

The concerns about the unintended consequences of post-crisis financing have been exploited, if not manipulated by opponents to reforms. Bankers in particular have raised this concern and surely have exaggerated it to oppose the new Basel III prudential framework, which sets higher standards for banks for capital requirements and leverage. Yet the potential risk for short- and medium-term financial stability and LTI objectives to clash should not be brushed aside. Regulators need to be able to distinguish between ‘productive risk’ (or ‘good risk’) and ‘unproductive’ or speculative risk, when setting or reviewing financial prudential norms for institutional investors, banks and insurance groups and funding rules for pension funds. Making such a distinction is possible in theory (Lazonick and Mazzucato 2012) but it has not yet been done in practice at government and policymaker level.

4.3 Financial products and reporting standards

A further barrier is the lack of marketable products that meet LTI criteria to fulfil the scale and liquidity requirements for institutional investors to
shift strategy: transparent products that can combine performance, security, transparency and traceability of investment into LTI projects, such as low-carbon projects or long-term infrastructure.

Here too the lack of climate change investment products is a case in point. The current green bond market value (i.e. the stock) is estimated at USD 16 billion. For the OECD (Della Croce et al. 2011) this is ‘a drop in the ocean’ of the USD +95 trillion value of world bond markets, while annual green bond issuances (i.e. the net inflows) are in the range of USD 1-2 billion (compared with some USD 6 trillion worth of issuances of ‘normal’ bonds). The availability of insurance products, including standardised and non-standardised derivative products to help manage and mitigate risks that are specific to LTI projects, would also needed to be enhanced, if they are to be properly regulated and supervised by authorities. This is not yet the case, as the recurrent delays in the reform of the over-the-counter derivatives markets has shown.

Further down the investment chain, it would also be appropriate for issuers (i.e. listed or private companies) to observe common long-term reporting requirements and to disclose and report on environmental, social and governance (ESG) performance and impact, making sure that the right information is available to investors regarding responsible LTI. We are still far away from mainstreaming ESG reporting. The prospect of ‘integrated reporting’ as promoted by the Global Reporting Initiative would help put ESG reporting on equal footing with financial reporting when considering the company’s risk management and risk reporting framework.

4.4 Leadership by asset owners and accountability of asset managers

Asset owners should exercise strong leadership to hold asset managers to account. This is needed because asset managers may have vested interests that are not aligned with those of their clients. Yet, asset owners are not visible in the policy debate on the structural shortage of long-term capital (White 2013). In the case of pension funds, leadership requires board independence that prevents conflicts of interest with asset managers and other financial service providers. That in turn requires accountability to members of pension schemes through member-nominated trustees. It is no coincidence that all pension fund leaders in
investing in clean energy have pension member and worker representatives on their boards.

Beyond board independence, asset owner leadership also needs to translate into board confidence in the merits of shifting further toward responsible LTI. That confidence can be achieved by ensuring that the legal framework for fiduciary duties does not constitute a barrier to responsible LTI. This relates to an old debate on the definition of the fiduciary duties and the extent to which it allows for long-term non-financial material risks – environmental, social, human right risks – to be explicitly taken on board.

Another reason for the lack of asset ownership leadership is the decade-long lengthening of the ‘investment chain’. The traditional ownership model – an asset owner and an owned asset – is no longer relevant. The multiplication of intermediaries (asset managers and the many associated consultancies) is creating major complications for asset owners who wish to ensure proper accountability of how their funds are being invested. A lot of recent literature points out to these problems, not least in the UK (Kay Review 2012) (see on this issue also the chapter by Williamson in this volume).

What needs to be done? For a start, the contract that binds the asset manager to the asset owner, including remuneration and extension of contract clauses, should encourage the asset manager to take a long-term...
view of portfolio performance. Such long-term metrics should naturally tone down the importance of quarterly (three month) performance benchmarks. That is rarely the case, and it is only recently emerging as a best practice. Achieving this is even harder when the bargaining power tilts in favour of the asset manager or when there is no transparency for asset managers’ fees and remuneration structures and other related costs and charges.

Setting robust contractual standards is also needed to ensure that ownership rights that asset managers ‘hold’ on behalf of asset owners (including shareholder voting rights) are effectively exercised. Disclosure of institutional investors’ voting policy and the exercise of voting rights by asset managers should be mandatory, yet there too regulation is lagging behind in several OECD countries.

Shareholders’ rights should have some meaningful impact on the CEO and the board of directors, including the right to propose resolutions for the agenda of the annual general meeting. But these rights need to reward, not harm those who act in the long-term interests of the company and penalise those seeking quick gains. Enhancing shareholder rights is a double-edged sword. They can be exercised in a responsible manner – ensuring board accountability and preventing management entrenchment to achieve LTI strategies – but surely they can also be used to further short-termist and speculative goals – as is the case of activist hedge funds engaging in ‘rampant takeovers’.

The challenge for regulators is to avoid the two objectives of 1) promoting shareholder rights for LTI and 2) curbing those same rights to prevent speculative behaviours from happening, from becoming mutually exclusive. The two track approach to LTI – positive and negative list – clearly applies in that case. In a positive list approach, some countries grant additional voting rights to long-term shareholders (e.g. those that hold shares for a certain minimum period of time, such as one year). But rather than rewarding long-term ownership, proponents of a negative list approach to LTI might argue that much could be done to penalise short-term, speculative behaviour, such as share lending and the use of derivatives to hide real share ownership.
4.5 Financial sector concentration

Finally, the level of concentration of the financial sector may also create structural challenges to asset management accountability. As shown in table 1, the majority of the world’s largest asset management companies are subsidiaries of global financial conglomerates that cumulate several banking and/or insurance services and are considered ‘too-big-to-fail’ by the G20 and the Financial Stability Board (e.g. Goldman Sachs, Morgan Stanley, JPMorgan, Société Générale, Deutsche Bank, UBS, HSBC, etc.) and of global insurance companies (e.g. Allianz, Prudential, AXA, etc.). When that happens, there is a risk of conflict of interest: the asset management branch may be inclined not to exercise shareholder rights that it holds on behalf of its clients, if the outcome could be seen as hostile by the CEO and management of the invested company and hence could threaten business relationships with other subsidiaries of the conglomerate.

Greater transparency of group-wide business relationships and strict rules to prevent conflicts of interest, such as ‘Chinese walls’ shielding the asset management subsidiary from undue pressure and influence from the group headquarters, can help of course. But one may well believe that, since the risk of conflicts of interest is structural – i.e. inherent to the business model of conglomerates that are too-big-to-fail – the definitive solution must be structural as well. In turn, this brings new light to the on-going, but yet controversial, policy debate on the need to force the dismantlement of too-big-to-fail groups by legally separating retail commercial banking from speculative and volatile investment and trading activities.

5. But do we really want this to happen?

Assuming that all the above requirements for an effective policy and regulatory road to LTI would come into effect, one may still question whether the entire LTI agenda could backlash and have unintended consequences for other parallel policy agendas. Is achieving a full LTI agenda a desirable outcome in the end? Could the costs outweigh the benefits? In what follows we discuss two areas of potential concerns: when the public purse is solicited and when public service and public administration capacities are being pressured.
5.1 The risk of privatising gains and socialising losses

In the short and medium term, considering the regulatory challenges ahead and the time for transition to an LT-friendly environment to take place, government support is needed. The most common form of support is a government guarantee on the credit default risk of an asset. For example, with a few notable exceptions, all ‘green’ bond issuances to date have been accompanied by explicit guarantees by governments, regional development banks or the World Bank. Such a guarantee allows a green bond to be rated ‘AAA’ (and hence be eligible for purchase by regulated

investors such as pension funds), whereas its stand-alone rating would have been closer to a BBB rating, which is too low for many regulated investors. Government support for LTI financing can take other forms however: subsidised low-interest direct loans, export credit insurance and facilities, foreign exchange risk insurance and subsidised support services for investment deals. State-funded/run venture capital funds can also take ‘first equity loss’ positions in private investment deals.

There are good reasons to support and indeed expand government guarantees to help increase private financial flows to LTI. However, past experience with the post-2008 bailing out of crisis-hit banks shows that government guarantees are a delicate policy issue. As evidenced by OECD experts and shown in the graph below, government guarantees and other forms of contingent liabilities are equivalent to 20-30 per cent GDP for most OECD economies and have grown substantially between 2008 and 2010. The underlying issue is whether these massive public guarantees benefiting bankers have in effect transformed the entire industry into a publicly subsidised business. Andrew Haldane (2010) of the Bank England estimates that the explicit and ‘implicit’ public guarantees represented a net saving of some USD 160 billion in 2009 for 13 banks in the UK alone. The Swedish central bank (RIKSBANK 2011) estimates that the average yearly reduction in funding costs for the four largest Swedish banks amounts to some USD 4.5 billion.

Figure 3  The rise of contingent liabilities as a percent of GDP across G20 economies, 2008-2010

Source: ITUC & TUAC (2012).
Public support to private finance does not come free. It needs to be priced appropriately. Fair and transparent risk-sharing arrangements should prevail whenever public money is used to support private projects. This is needed to protect the public interest (i.e. to avoid ‘privatising gains and socialising losses’) but also to avoid unfair competition in the financial sector. Importantly, the need for ‘leveraging’ private finance should not be mixed with, or transformed into some unconditional subsidisation of bankers and of asset managers, and/or situations in which profits and gains are privatised, while deficits and losses are socialised.

5.2 The need to protect public services

The second area of concern is with the risk posed by LTI to the much needed protection and development of public services and public administration capacities. Mobilising institutional investors for financing infrastructure could for example end up in substituting (or ‘crowding out’) publicly controlled and financed investments and the promotion of public services, particularly in developing countries.

In many cases mobilisation of institutional investors would involve promotion of Public-Private Partnerships (PPP). PPPs account for less than 15 per cent of the total asset value of public sector infrastructure investments in countries that are considered as leaders in promoting PPPs, such as South Korea and Australia, and for less than five per cent in Canada, Germany, Italy, South Africa, Norway and Spain (OECD 2013b). But PPPs are becoming more important and feature prominently on the LTI-related global agenda. The suggestion that PPP should be considered as a preferred option for financing infrastructure relative to traditional public procurement does not hold in our view. In practice, PPPs have proven to be a flawed model that can lead to over-priced public services as well as to situations where gains are privatised and losses are socialised. In contrast to traditional public procurement, PPPs have many hidden costs and have excessively complex contracts for governments to handle (TUAC 2010).

Best practice for testing the extent to which risk-sharing arrangements under a PPP project are in line with the public interest consists in always applying a ‘public sector comparator’, that is: comparing the costs and benefits of a given PPP project with the alternative solution of public sector procurement. And where PPPs should indeed be considered in
their own right, the projects should be based on a thorough analysis of real needs, appropriateness on the longer term, fair risk sharing for the community and accessibility and affordability of the services and goods produced. They should genuinely respect a multi-stakeholder approach.

6. Conclusion

The road to shifting institutional investors toward a long-term investment strategy may at first sight appear to be a massive highway. The barriers to long-term investment as well as the incentives for short-term speculation have been identified in this and other chapters in this volume.

However, a shift towards increased long-term investment by institutional investors makes sense from a stakeholder point of view because of their long-term liability profile, particularly of pension funds, but also because it would help divert investors away from short-termist speculative behaviour and promote macroeconomic stability. But there are many caveats. The crucial challenge is to restore accountability along the investment chain, and to rebalance the power relationship between asset owners and asset managers, in conjunction with strong reporting requirements. Long-term investment is a policy priority, but some inconsistencies remain. In defining LTI, the emphasis should be on the investor’s holding period, as in the OECD definition, rather than the asset’s maturity.

Regulatory and macroeconomic factors pose challenges as well. Financial regulation and prudential norms should to the greatest extent possible distinguish between ‘good’ and ‘bad’ forms of risk, in order to facilitate the supply of quality, long-term investment. Post-financial crisis regulatory tightening, though necessary, has had some unintended consequences on the supply of LTI. Quantitative easing and reporting standards, in particular, have contributed to low interest rates and incentives for short-term behaviour.

Moving forward, pension funds should keep in mind their central role as asset owners and stewards of workers’ capital. The example of clean energy finance has shown the potential of investors, especially pension funds built on collective bargaining, to provide sustainable, long-term financing.
Yet from a progressive perspective which is shared by the labour movement and civil society groups, there are crossroads on the road ahead, including the protection of public services and of strong and efficient public administrations. We should avoid a zero-sum situation at all cost; any long-term investment agenda should add-on to, not substitute for citizens’ right to public services and to effective government institutions.

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Annex: Calculating pension funds’ theoretical potential to finance climate change-related projects

What is the financial potential of pension funds to increase, in a reasonable way, their exposure to climate change projects? Based on previous trade union work (ITUC and TUAC 2012a) and OECD research (Della Croce et al. 2011) we can make a broad estimate. To do that we first need to select a global pool of pension funds that is most likely to have the ability to invest in climate change financing:

— The total market value of assets under management by occupational pension funds worldwide at the end of 2010 was estimated at USD 19.3 trillion, or USD 27 trillion if one adds public pension reserve funds. But not all pension funds will be able to engage in climate change financing for various reasons. The decisive factor seems to be size: large schemes can invest in climate

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2. This annex is based on scenarios developed in 2013.
change investments, whereas smaller ones cannot. Unfortunately a size indicator is not readily available at global level.

— As a proxy indicator for pension size we use the share of defined benefit (DB) schemes. Because they are often established as part of collective bargaining agreements DB schemes are most likely to be large in size. According to Towers Watson, DB schemes account for 56 per cent of total assets under management worldwide, i.e. about USD 10.87 trillion.

— Regarding public pension reserve funds, we select all the funds because they are large in size by definition. We do however exclude the US Social Security Trust Fund because by law it is required to invest 100 per cent of its portfolio in US Treasury bonds, and hence will very unlikely invest in anything else.

When combining the occupational DB funds (USD 10.87 trillion) and the (non-US) public pension reserve funds (USD 5.17 trillion) we obtain a pension fund universe that potentially could contribute to climate change financing of USD 15.98 trillion assets under management. With that pension universe in mind, we then make the following assumptions:

— Current pension fund investments and exposure (i.e. current share and future commitments) are below one per cent, hence leaving considerable room for increase before exposure becomes problematic from a risk diversification perspective;

— Total portfolio grows by +2.0 per cent annually in 2012-2017, +2.2 per cent in 2018-2030 and +1.9 per cent in 2031-2050. These figures correspond to the OECD (2012) assumptions about real GDP growth. They should be conservative enough to factor in the current global economic crisis and its long-term impact, and considering that past global pension annual asset growth was +4.6 per cent between 2005 and 2010 (+4.3 per cent for the US pension funds).

— The above projection is a reasonable one if – and that is a big if! – no systemic event takes place during the period. Such an event

3. This is however not always the case: DC schemes in Australia for example, are large and concentrated and would certainly have the ability to invest in climate change-related products.
could be a financial crisis on the scale of 2008 combined with a demographic shock in the ageing OECD societies, which would occur on such a scale that pension schemes are forced to heavily divest in order to face exploding pension liabilities.

Based on these assumptions, we then can construct three scenarios for raising pension fund exposure to climate change financing:

— An annual portfolio re-allocation to clean energy infrastructure funds of +0.2 per cent between 2013 and 2027 and +0.1 per cent between 2028 and 2050. This is a conservative hypothesis considering that the current exposure of pension funds to clean energy funds is extremely low and that over the period the cumulative exposure would remain below five per cent (4.3 per cent in 2050), which would be consistent with prudential funding rules. Some pension funds might be able to scale up their private investments more rapidly. But we should bear in mind that climate change-related investments will to a great extent take place in emerging and in developing economies – which is far away from the home base of the vast majority of the pension funds (90 per cent being located within the OECD). Geographic distance (and the regulatory and currency risks that go with it) adds to other structural barriers that are specific to private funds such as illiquidity and transaction costs (e.g. contract negotiations and access to expertise).

— An annual portfolio re-allocation to green bonds of +0.75 per cent for 2013-2015, +0.5 per cent for 2016-2019, +0.4 per cent for 2020-2023, +0.3 per cent for 2024-2030, +0.2 per cent for 2031-2040 and +0.1 per cent for 2040-2050. This is also assumed to be a reasonable projection given the popularity of fixed income investments among pension funds and the need to ensure that the cumulative exposure (reaching 11 per cent in 2050) remains within prudential norms. This is a realistic projection as long as supply side bottlenecks are rapidly resolved.

— An annual portfolio re-allocation to climate change-related equity indices of +0.75 per cent for 2013-2015, +0.5 per cent for 2016-2020, +0.4 per cent for 2021-2026, +0.3 per cent for 2027-2032, +0.2 per cent for 2033-2037, +0.1 per cent for 2038-2042 and +0.05 per cent for 2043-2050. There too, the projection would not be too demanding for pension funds, and the annual re-allocation
would gradually decrease to take into account prudential norms (total exposure reaching 10.9 per cent in 2050). But here too supply side problems exist, and are arguably on a greater scale than for green bonds, given that equity indices that are ‘truly’ climate change-related are few (in contrast with broader ‘sustainability’ indices).

In turn this leads us to three alternative scenarios, each with a different combination of the above hypotheses.

Table 2 Assumptions underlying three scenarios for climate-change financing

<table>
<thead>
<tr>
<th>Annual shift in the portfolio 2013-2050</th>
<th>Scenario I</th>
<th>Scenario II</th>
<th>Scenario III</th>
</tr>
</thead>
<tbody>
<tr>
<td>From +0.2% to +0.1% to clean energy infrastructure funds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>From +0.5% to +0.1% to green bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>From +1% to +0.1% to climate change equity indices</td>
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Table 3 Three scenarios for pension fund exposure to climate-change financing

<table>
<thead>
<tr>
<th>Year</th>
<th>Scenario I</th>
<th>Exposure</th>
<th>Scenario II</th>
<th>Exposure</th>
<th>Scenario III</th>
<th>Exposure</th>
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<tr>
<td>2013</td>
<td>34</td>
<td>0.2%</td>
<td>161</td>
<td>1.0%</td>
<td>289</td>
<td>1.7%</td>
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<td>2014</td>
<td>35</td>
<td>0.4%</td>
<td>165</td>
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<td>295</td>
<td>3.4%</td>
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<tr>
<td>2015</td>
<td>35</td>
<td>0.6%</td>
<td>168</td>
<td>2.9%</td>
<td>301</td>
<td>5.1%</td>
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<tr>
<td>2016</td>
<td>35</td>
<td>0.8%</td>
<td>126</td>
<td>3.6%</td>
<td>217</td>
<td>6.3%</td>
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<tr>
<td>2017</td>
<td>37</td>
<td>1.0%</td>
<td>129</td>
<td>4.3%</td>
<td>221</td>
<td>7.5%</td>
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<tr>
<td>2018</td>
<td>19</td>
<td>1.1%</td>
<td>113</td>
<td>4.9%</td>
<td>207</td>
<td>8.6%</td>
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<tr>
<td>2019</td>
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<td>116</td>
<td>5.5%</td>
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<tr>
<td>2020</td>
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<tr>
<td>2025</td>
<td>22</td>
<td>1.8%</td>
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<tr>
<td>2030</td>
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<tr>
<td>2050</td>
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<td>Annual average 2021-2030</td>
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<td>175</td>
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<tr>
<td>Annual average 2031-2040</td>
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<td>Total 2013–2030 period</td>
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In terms of net annual contribution, our projections show that:

— Under scenario I (clean energy infrastructure funds only) some USD 34 billion could be re-allocated to infrastructure and private equity funds in 2013 and then fluctuate around USD 22-33 billion until 2050. The total investment flows would reach USD 457 billion between 2013 and 2030 and USD 1514 billion between 2013 and 2050.

— Under scenario II (clean energy infrastructure funds + green bonds) USD 161 billion could be re-allocated in 2013 (USD 34 billion to private funds + USD 127 billion to green bonds); allocations would then gradually decrease to some USD 100 billion in 2020, and fluctuate around USD 70-90 billion hereafter. Total flows would reach USD 2028 billion for 2013-2030 and USD 3499 billion for 2013-2050.

— Under scenario III (clean energy infrastructure funds + green bonds + climate change equity indices), USD 289 billion would be reallocated in 2013, USD 197 billion in 2020 followed by a gradual decrease to some USD 90 billion in 2040. Total flows under that scenario would reach USD 3684 billion for 2013-2030 and USD 5856 billion for 2013-2050.
Chapter 5
Trade union influence on companies via pension fund investment

Gerald Klec and David Mum

1. Introduction

This chapter analyses the extent to which trade unions are attempting to reduce the gap between factual ownership and lack of control over workers’ capital managed by pension funds and to exercise influence over the companies this capital is invested in. It is concerned with an attempted democratisation of the economy by trade unions exerting influence via rights derived from securities held in pension fund portfolios. This is also called the ‘active approach’ to principle-based investment or socially responsible investment (SRI). Reducing this gap would be a major step in the direction of promoting long-term sustainable investment, thus supporting the Sustainable Company. The major focus of the analysis is the United States, but Canada, the United Kingdom, the Netherlands, Switzerland and Austria are also examined. The selection of countries was based on the relative significance of company pension funds, as well as on the basis of trade union activities in this area and the research activities and experience of the authors.

In 2007, before the outbreak of the financial market crisis, financial assets worldwide totalled around USD 200 trillion (Roxburg et al. 2009). Whereas in 1980 total financial assets roughly equalled annual global value creation, by 2005 they were roughly three times greater than value created (Share the World’s Resources 2012). These figures illustrate the growing relative size of financial markets vis-à-vis the real economy.

Simultaneously with the increasing dominance of the financial markets came the rise of institutional investors. Pension funds managed around USD 28 trillion in 2007 (Huffschmid 2009: 4), which amounted to around 14 per cent of total financial assets globally. Since the predominant purpose of pension funds is retirement provision for workers, this means that a considerable proportion of global financial assets belongs to workers. However, the latter have little control over how
these resources are used. Capital is largely under the control of the financial industry, which often acts to the detriment of the real economy and workers' labour and employment conditions.

Pension funds invest in both government and corporate bonds, as well as ownership stakes in companies in the form of shares. On top of this are real estate investments and alternative forms of investment (e.g. hedge funds and private equity). Due to the increasing significance of funded old age provision through the increased involvement of funded elements in public pension systems, as well as the fact that funded company pension systems in many cases are still in the development phase, the proportion of companies that belongs to workers via the equity investments of pension funds has risen sharply in recent decades. According to one estimate, in 2000 pension and investment funds in the United States owned around 45 per cent of all shares (Bundestag 2002: 66). According to the New York Stock Exchange (NYSE), the proportion of US shares held by pension funds rose from 0.8 per cent in 1950 to 20.6 per cent in 2001.

Figure 1  Proportion of US shares held by pension funds (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>US shares held by pension funds (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>0.8 %</td>
</tr>
<tr>
<td>1970</td>
<td>9.2 %</td>
</tr>
<tr>
<td>1990</td>
<td>24.2 %</td>
</tr>
<tr>
<td>1995</td>
<td>23.2 %</td>
</tr>
<tr>
<td>2000</td>
<td>20.0 %</td>
</tr>
</tbody>
</table>


1. In the development phase of a funded provision system there are relatively many prospective beneficiaries for whom contributions are paid into the system, as against (still) relatively few beneficiaries. As a consequence of this the capital stock grows systematically. This effect no longer manifests itself once capital additions and withdrawals are balanced by a correspondingly high proportion of beneficiaries.
In other words, the development of funded old age provision through pension funds has led to marked changes in the ownership structure of listed companies.

2. Different approaches to SRI

2.1 Theoretical work on pension funds

As early as 1976 Peter Drucker in the United States coined the term ‘pension fund socialism’ to describe changed ownership structures due to the advent of institutional investors. According to Drucker, if one defines socialism as ownership of the means of production by workers, the United States is the first socialist country. Drucker was referring to the fact that in 1976 pension funds already owned 26 per cent of equity capital, by means of which they could have controlled the economy (Minns 1996: 46). Drucker forecast that pension funds would hold 50 to 60 per cent of share capital within 10 years (Drucker 1976: 1). He asserted that this change had barely been noticed hitherto and its significance had not been recognised (‘The revolution no one noticed’). Drucker claimed that the Swedish model of capital accumulation in the hands of workers, which was being discussed at that time, would have to operate for 25 years before it could achieve what had already been achieved in the United States by 1975 (Minns 1996: 46).

For many neoliberals this was a decidedly threatening scenario. For example, the leading market liberal Milton Friedman took the view that fully funded social insurance with high share prices could provide a way for socialists to achieve dominant control through the state over the economy.

Many authors qualifying Drucker’s remarks have pointed out that, although the ownership structures of listed companies has shifted strongly in favour of institutional investors, this has not been accompanied by any shift in company control to the workers. Jeremy Rifkin and Randy Barber asserted in 1978, in their book The North Will Rise Again, that workers must ask themselves whether they are willing to continue to allow their own capital to be used against them or whether they want to achieve control over pension funds so that their capital is invested in such a way as to rescue jobs and regions.
Since then there has been much discussion of how workers can obtain more control over their capital and trade unions have also engaged in significant activities in this connection. In 2003, Joe Guinan called for a capital strategy of the Left to overcome the gap between formal ownership and real control. The French co-founder of regulation theory Michel Aglietta asserted that shareholders had exchanged control rights for liquidity. The more liquid the financial markets, the further away from companies the shareholders are. He thus called for social capital ownership. Savers should be involved in decision-making processes concerning investment strategies. Performance indicators for evaluating companies should be expanded (e.g. significance of human capital, research and development, working conditions in developing countries, improvements in environmental protection) and the time horizon for measuring investment returns should be extended to three to five years.

Ewald Engelen, on the other hand, took the view that the goals of old age insurance and the achievement of more control over the economy by workers are fundamentally contradictory. Saving for old age requires risk diversification. The more diversified investments are, however, the lower will be the control over individual companies. Furthermore, in many pension fund boards workers do not have equal representation. The engagement activities of pension funds are concentrated on corporate governance issues. Ultimately, this leads to a strengthening of the shareholder ideology. The screening of investment portfolios is a blunt instrument when it comes to changing companies’ behaviour.2

2.2 The passive approach

In the case of the so-called passive approach to principle-based investment, the focus is on the selection of pension fund securities portfolios. The exertion of influence over companies with whose social, ethical or environmental performance one does not agree takes place via the securities markets. Principle-based investors sell and no longer invest in the shares of companies with whose behaviour they do not agree. Such

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2. Screening involves the targeted selection or exclusion of investment funds or individual shares on the basis of certain criteria. Screening thus means the application of positive, negative and exclusion criteria. For example, companies active in the arms industry or nuclear power can be excluded from the portfolio. On the other hand, with an active approach investors exercise their voting and participation rights and thereby try to achieve certain ends.
behaviour, given the extent of SRI share ownership, could theoretically affect share prices. However, such an effect is empirically not discernible: companies can still get access to capital if they are avoided by SRI investors.

This approach, which is also known as ‘screening’, requires comprehensive analysis, which is provided by companies specialising in SRI. The application of exclusion criteria is relatively simple. Based on these criteria certain branches or companies are excluded from investment portfolios, for example, nuclear power or tobacco. In the case of the Best-in-Class approach, by contrast, no branches are excluded a priori. Rather the ‘best’ companies are selected for investment from each branch. In other words, those companies are chosen which have a higher than average rating in accordance with certain criteria, such as environmental efficiency, social considerations or dealings with stakeholders within and outside the company. The Best-in-Class approach requires detailed analysis in order to be able to rank individual companies. Within the framework of this approach and SRI ratings it is expected that competition will emerge between companies with regard to their social, environmental and governance performance. Further investor groups can be accessed by acceptance in a sustainability index or a sustainability fund.

A passive approach to principle-based investment can be achieved more cost effectively than an active approach, especially if existing funds are invested in companies fulfilling the SRI criteria of the investor. In Continental Europe the passive approach is more widespread than in North America. Ethical and environmental criteria are in the foreground here, with social criteria somewhat less important.

2.3 The active approach

The active approach to SRI through engagement utilises the opportunities offered by shareholders’ rights. On this basis dialogue with companies is pursued in order to steer their behaviour in a desired direction. By exercising voting rights based on shareholdings this pressure can be increased. In this area significant progress has been made in recent decades. Institutional investors join forces for the purpose of concerted engagement or vote on the basis of recommendations.

In support of the exercise of voting rights proxies and the delegated exercise of voting rights are organised. Furthermore, analyses of
shareholder meeting agendas are sometimes prepared with specific voting recommendations. For a more universal application recommendations of a general nature are issued for certain typical agenda points.

Statutory requirements have encouraged this. In some countries, such as Switzerland and the United Kingdom, pension funds must state whether and in accordance with what criteria they exercise voting rights arising from shares. Although this is not obligatory for the exercise of voting rights, these regulations in general have led to the strengthened and more critical use of these rights. While the pension funds previously either stayed away from general meetings, were present but did not vote, or for the sake of simplicity uncritically accepted management proposals, voting rights are now increasingly exercised, sometimes in concert with other institutional investors. Major institutional investors take the approach ‘voice before exit’. Before the institutional investor sells his securities because he does not agree with the company’s policies, he attempts to exert a positive influence on the company’s activities. In the United States, investment funds have been obliged since 2003 to report on their voting behaviour at the general meetings of those companies in which they have shareholdings. Practical problems arise in particular for smaller investors who do not hold securities directly, but rather within the framework of an investment chain have invested in a fund that holds these securities. Even with good intentions in such cases exercise of voting rights is often not possible because there is no legal right to the use of voting rights arising from securities.

Another problem for exercising voting rights – the need for a physical presence at general meetings – has declining significance since large companies are increasingly allowing voting over the internet or by postal vote. Shareholders themselves have been active in this regard and have been able to increase their presence at general meetings by organising systems of mutual proxy voting and by using proxy voting services. The percentage of the share capital for which votes are cast at general meetings has increased in Switzerland, for example. Eumedion in the Netherlands organises proxy voting for its members, which include many Dutch pension funds. Within the framework of the ‘Shareholder Communication Channel’ full power to exercise voting rights can be conferred on a central representative.

Dialogue with the company, in other words, the active approach to engagement, is associated with considerable expenditure of resources
unless it is carried out via bundled services. Engagement is effective only when activists have significant shareholdings at their disposal.

3. Pension fund investment and trade unions

3.1 The trade union position on activism

Trade unions in the United States, Canada and the United Kingdom prefer engagement to screening. The British TUC makes the point that the screening approach forces pension funds to withdraw from many investments. Divestment is a one-off act, however, which means that influence can no longer be exerted over the company to get it to change its behaviour. In contrast, engagement changes neither the portfolio nor the risk profile of the pension fund.

Trade unions that were directly or indirectly involved in the management of second-pillar pension resources in various countries began to address this issue starting in the 1990s. The importance of company pensions within trade unions’ range of tasks depends in particular on the significance of the second pillar in the overall system of old age provision in the given country. While in countries such as the United States, the United Kingdom, Switzerland and the Netherlands company pension provision receives much attention due to its great weight, in countries such as Austria and Germany the issue doesn’t play such a significant role. Addressing these issues is controversial among trade unions because in a way it implies acceptance of funded pension provision. The trade union position tends to focus on demands for a strong pay-as-you-go funded pension system.

Trade union influence over pension funds in North America is more strongly anchored than in Europe. This is also due to the fact that the model of company financing in the United States is based much more on the issue of equity via the stock exchange, resulting in a higher volume of shares. In (continental) Europe, company financing takes place much more through external capital (banks) and even in the case of equity issues it is often the banks that hold company securities.

Trade union shareholder activism is a comparatively new phenomenon. The AFL-CIO began to dedicate resources to it in the 1990s, establishing an Office of Investment. The AFL-CIO has published directives on voting
behaviour, as well as – since 1997 – regular reports on the voting behaviour of investment managers. The AFL-CIO’s directives on voting behaviour overwhelmingly include corporate governance questions. These are directed against excessive management pay and the maximisation of profits in terms of a short-term perspective, leaving aside long-term interests. The AFL-CIO advocates that over 50 per cent of total management remuneration should depend on long-term incentives. The board of directors is supposed to control the management. It is thus supposed to be independent of the management. The AFL-CIO recommends that at least two-thirds of the directors should be independent of the management. Furthermore, an independent director – and not the CEO – should be chair of the board of directors. Proposals on better representation of women, employees or certain minorities are supported. Measures for decent jobs, such as further training, security of employment and a supportive work environment, should in general be demanded because this contributes to productivity and long-term financial performance.

The British TUC began to address engagement and pension funds systematically in 2003. The effect of this engagement was hampered by the fact that in the United Kingdom decentralised labour relations dominate, which hinders the development of nation-wide or branch-wide pension plans.

In Canada, trade unions tried from the 1980s to obtain more control over pension funds. In 2001, the organisation SHARE (Shareholder Association for Research and Education) was founded by the trade union movement in order to support pension funds in the interests of workers, to develop directives on voting behaviour and to promote engagement. In this country, trade unions are represented in the funds for public sector workers and have established themselves as important actors in the

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3. In Anglo-American countries most companies have a monistic system, in which the management is not institutionally divided from supervision. Both functions are undertaken by the same body, the board of directors. In the dualistic system, by contrast, the board of directors and the supervisory board are separate. Employees’ representatives, for example, are represented in the supervisory board of large companies in Germany and Austria, but not represented on the management board. The board members in the monistic system are elected only by the shareholders through the general meeting. The directors are usually divided into executive and non-executive directors. The executive directors undertake the operational management of the company. The non-executive directors are active primarily in an advisory and supervisory capacity and do not perform this office as their main employment.
improvement of corporate governance. The trade union-associated pension company Bâtirente in Quebec takes a comprehensive engagement approach focused on environmental, social and human rights issues.

A common endeavour is the effort to publicise information on the voting behaviour of investment funds and the level of agreement with the trade union directives in order to create transparency and a basis for the selection of funds by trustees.

3.2 Trade union codetermination options in pension funds

With regard to the involvement of employees’ representatives in pension fund governance individual countries exhibit various models. Trade unions as a rule cannot control the management of pension funds. If representatives of member workers in the funds are involved, they mainly comprise a minority on the board of directors or the supervisory board, at most making up half of the members.

There are pure company pension funds that are under the influence of the contributing company. While in the United States their management is mainly structured without employees’ representatives, in the United Kingdom one-third of members of the board must be nominated by the beneficiaries. In order to be able to achieve something, however, they must seek agreement with representatives of the employer.

In the case of multi-company pension funds, besides profit-oriented financial institutions, such as the Austrian pension funds, there are also (branch) funds administered by the social partners, such as the Taft-Hartley fund in the United States and the major pension funds in Canada and the Netherlands. In the United States and Canada the pension entitlements of public sector employees are also outsourced to funded pension funds. These often operate with the involvement of employees’ representatives.

In the case of financial institutions that offer individual pension plans on a voluntary basis via the employer there is no employees’ representation. However, trade unions have sometimes established trade union-related insurance institutions as providers of individual old age pension products (for example, Bâtirente in Quebec or the TUC Stakeholder Pension Scheme).
Most pension funds outsource investment to investment funds. These also exercise the voting rights attached to the shares.

In the United States, trade unions are represented mainly in pension funds for public sector workers, not, as a rule, in company pension funds, while in multi-company funds subject to a collective agreement – Taft-Hartley funds – workers are involved in the board on a parity basis and mainly nominated by the trade union. The Taft-Hartley Act limits the trade unions’ options for exerting influence because it makes it impossible for the trade unions to control a fund exclusively when the employer also makes contributions (Fogdall 2001: 215). In company funds the potential influence of trade unions is low. However, the volume of investment by company funds in the United States is four times larger than that of the Taft-Hartley funds, which are managed on a parity basis. In the United States union-sponsored pension plans with the involvement of the trade unions managed around USD 400 billion in 2007 (AFL-CIO 2007). That is only 2.3 per cent of pension capital, whose total value is USD 17.4 trillion USD. The pension funds for public sector workers could play a bigger role, managing USD 4.4 trillion (i.e. 25.3 per cent of total pension fund assets).

In the Netherlands, as in Switzerland, the management of pension funds is on a parity basis. In the United Kingdom representatives of the members in many company pension funds have one-third of the seats on the board. In Canada, trade unions are represented in the fund for public sector workers. In Austria, representatives of prospective and current beneficiaries are represented on the supervisory boards of the pension funds. They have two supervisory board seats fewer than employer representatives.

In short, there is no trade union control of pension funds in the countries under analysis and thus agreement on decision-making must always be reached with the employer’s representatives. In the best case there is parity representation, which can confer a veto right to labour. An exception to this is the trade union-affiliated pension institution Bâtirente in Quebec, which permits a much more independent approach to engagement than in institutions in which the employers are also represented and which has adopted a very ambitious activist approach. Bâtirente regards itself as not only obliged to offer the members low-cost pension arrangements, but also seeks to use the capital to influence company managements, in particular in Canadian companies, to be more responsible by taking into account environmental, democratic and social
matters. Bâtirente takes a very broad engagement approach which is not limited to aspects of corporate governance, but is also concerned with numerous environmental and human rights issues, since other institutional investors scarcely pay any attention to them.

3.3 Training and networking of pension fund trustees

Trade unions in the United States, Canada, the United Kingdom and the Netherlands try to bring together the representatives of the beneficiaries in the pension funds (pension fund trustees) and to provide services to these trustees so that in their activities they ensure the best possible management of workers’ money. In Canada, the organisation SHARE was founded for this purpose. The TUC links up around 1000 trade union-organised trustees. Since 2003 the TUC has produced an annual report on the voting behaviour of investment managers and in October 2004 it published directives on voting behaviour and engagement.

In German-speaking Switzerland a network was established by the trade unions to train and link up trustees (PK-Netz). In francophone Switzerland there is a network for trustees outside the trade union framework, although trade union federations can also be members (ARPIP). SRI and shareholder activism do not have a dominant role in this Swiss networking programme.

In the Netherlands the trade union FNV Bondgenoten conducts training courses that introduce trustees to the basics of company pensions and also SRI. In Austria, since 2008 the Union of Salaried Private Sector Employees, Graphical Workers and Journalists (GPA-djp) has been engaged in network building among representatives in the pension funds, which is directed towards members of pension fund supervisory boards who are also trade union members.

3.4 International trade union networking

The Committee on Workers’ Capital (CWC) was founded by the International Trade Union Confederation (ITUC), the OECD’s Trade Union Advisory Council (TUAC) and the Global Union Federations as a direction-setting institution in connection with the international promotion of SRI in pension funds.
The CWC operates with relatively low financial and staff resources. The aims of the CWC are achieved mainly through networking and the exchange of information. The CWC has published a series of briefing papers (for example, on forced labour). Much of the information made available by the CWC has been be used for the purpose of shareholder activism. Target groups are the trustees of pension funds.

Trade union national and branch umbrella organisations must increasingly act as multipliers so that individual trade unions also become aware of and utilise the work of the CWC. It is as a rule these individual trade unions that are in direct contact with the trustees of pension funds.

4. Different trade union approaches to shareholder activism and SRI

In the Anglo-Saxon countries and also in Switzerland the main focus of trade unions is on the exercise of voting rights arising from the ownership of securities. The Swiss trade unions and the British TUC also favour dialogue with the company (engagement). The focus on exercising voting rights in Switzerland derives among other things from the legal duty of the Swiss pension funds since 2002 to declare how the voting rights arising from share capital are used.

In the largest Dutch trade union FNV Bondgenoten there is no specific initiative concerning the exercise of voting rights. FNV Bondgenoten thus does not provide recommendations on voting rights for the voting behaviour of pension funds, unlike, for example, the British TUC and the AFL-CIO in the United States. In Switzerland, too, there is no direct trade union activity in this area. Initiatives come rather from the investment foundation Ethos, in which pension companies combine. In many national legal systems asset managers are not required to disclose how they use the voting rights that they exercise for their customers.

In Europe, in general the labour relations culture differs markedly from that of North America, which also manifests itself in the context of pension fund activism. In the United States, there is systematic and institutionalised dialogue between the company management and the trade unions only to a very limited extent. The trade unions, which own considerable portfolios of shares via their pension funds, thus have a major interest in exercising their shareholder’s rights in order to insist
on dialogue or to enforce their standpoint on voting in general meetings (or the related publicity).

In contrast, the European social and company model is far more than a dialogue between employers and employees’ representatives. Company codetermination is partly institutionalised, in particular in countries with the dualistic model of corporate structure, such as Germany, Austria and the Netherlands, but not Switzerland or the United Kingdom. The dialogue between the employees’ side and companies thus takes place along a different track in Europe and does not have to take a detour via funded pension schemes.

In Europe thus the approach to the exercise of shareholders’ rights is mainly consensus-oriented and many investors tend to be passive. In the first instance, a constructive dialogue with companies is sought – for example, the Ethos Engagement Pool in Switzerland. Although the exercise of voting rights is also cultivated in Europe, it is done in a less conflict-oriented manner than in North America. Ethos in Switzerland and the Shareholder Communication Channel in the Netherlands are initiatives for bundling voting rights and for exercising voting rights for others. In the United States the pension funds of public sector workers – such as CalPERS (California Public Employees’ Retirement System) – and union funds sometimes issue public voting rights recommendations, criticise the management and approach the shareholders with open letters.

European and North American trade unions take different positions on more shareholder democracy and safeguarding companies’ independence through the company statutes. While US and Canadian trade unions reject so-called ‘poison pills’, which protect companies against hostile takeovers, the German DGB is in favour. American trade unions take the view that such provisions could also hinder company takeovers that could be in the interests of shareholders. Poison pills would thus, in the view of the US trade unions, primarily safeguard the existing management. The AFL-CIO is against anti-takeover provisions introduced without the assent of the shareholders.

In recommendations for trustees in the case of takeover bids the US trade unions leave out the question of whether they will have negative effects on the employees via synergy effects. The reasons for rejecting or accepting takeover bids in the directives and concrete recommendations
that the authors looked at were always based on whether the level of the bid was regarded as fair for the shareholders and what effect the takeover would have on the future value of the relevant company. This shows that the demand that only decisions may be taken that are in the interests of prospective beneficiaries prevents the trade unions from emphasising their core positions within the framework of pension fund investment. The US trade unions also reject more strongly weighted voting rights for long-term shareholders because it contradicts the principle ‘one share, one vote’. The long-term approach should apparently be established above all via adapted incentives in the remuneration systems of managers.

5. Difficulties with regard to trade union influence

Legal guidelines within the framework of company pension provisions limit the extent to which trustees can be used for trade union goals. To act in accordance with these guidelines trustees in pension funds have to make decisions and act exclusively in the interests of beneficiaries. All engagement activities are subject to the filter that they must be in the interests of beneficiaries and may not have a negative effect on the value of portfolios. In the United States, it is even laid down that, in the case of votes, trustees must exercise their voting rights in such a way that they have a positive influence on the share price. Shareholder activism is thus regarded as compatible with trustees’ duties if it can lead, after taking costs into consideration, to an increase in the value of the company. The trustees’ duties and the character of the assets in pension funds as pension capital thus limit their possible use for activism in the service of trade union concerns. In Canada, too, according to SHARE, the fear of infringing trustees’ duties hinders the application of non-financial criteria in investment.

The question of what precisely is in the interests of beneficiaries – whether within the framework of the pension fund’s investment process it is merely the value of the portfolio or whether it includes other matters, such as environmental and social performance – is not defined in the law and has to be legally determined on a case by case basis. The time horizon also plays a significant role in this assessment. The high diversification of investments, which is to be welcomed from the risk minimisation standpoint, means that pension funds tend to have such small shareholdings in companies that as a rule it is impossible to influence the company management effectively.
By way of defining and interpreting the duties of trustees the legislature can hamstring engagement or restrict it considerably. Thus the possibility of changing company behaviour by utilising workers’ capital always depends on the political determination of trustees’ duties and the approval of politically motivated motions. Trade unions should thus support legal clarification of the point that taking into account non-financial criteria does not constitute an infringement of trustees’ duties.

In one instance in the United States, for example, the Securities and Exchange Commission (SEC) declared that the AFL-CIO campaign in 2005 against those financial investors who supported the plans of the Bush administration to privatise social security was not compatible with trustees’ duties. Four companies supported the proposals of the Bush administration by establishing the Alliance for Worker Retirement Security. As a consequence of the AFL-CIO’s campaign two companies withdrew from this alliance.

Particularly striking was the threat of the Republican leadership in California to break up CalPERS and to distribute the capital on the basis of individual contracts with different providers. In this way, any chance of trade union influence would have been ended.

Against this background political campaigns by trade unions via their influence over pension funds are very hard to implement. If engagement activities are to take place in the area covered by the law they must pay close attention to aspects of corporate governance. If shareholders’ motions are put forward within the framework of the exercise of voting rights their justification tends to be aimed at governance or the possible negative effect of certain business practices on shareholder value. Possible lines of argument can also include working conditions and environmental aspects. This is because neglecting the interests of employees or environmental risks could also negatively influence the value of the company. On this basis US trade unions have put a number of motions against company managements. Although such motions scarcely find majority support they can direct public attention towards companies’ problematic practices.

Many shareholders’ motions call on companies to comply with ILO core labour standards. It would scarcely be possible in motions to call for a stronger influence for the employees in the corporate decision-making process. Such motions would encounter little support among the other
shareholders. In 1996–2005, out of 926 motions put by trade union pension funds in the United States, eight motions called for representation of the employees in the board of directors.

Campaigns are launched from time to time concerning working conditions. The TUC supports the ‘Just Pay’ campaign launched by FairPensions (TUC 2012). This calls on pension funds to put pressure on companies so that they commit themselves to paying fairer wages and salaries that represent a living wage for families. Such wages are above the statutory minimum wage. In the United States, the trade union AFSCME, which organises public sector workers, was able to get pension funds for such workers not to invest in companies that pursue privatisation. A similar anti-privatisation clause that prevents private equity funds from investing contributions in companies that promote privatisation was agreed in four pension funds.

In North America the trade unions with real estate investment funds (ETIs) have issued special investment products. This promoted the creation of affordable housing for groups of beneficiaries with fair working conditions in the course of construction and trade union recognition. Because of risk diversification, however, the shareholding in the portfolios of union funds is limited to a few per cent.

6. Effectiveness of exercising voting rights

The trade unions in the United States have managed to establish themselves as the most significant figures in shareholder activism. Between 1996 and 2005 trade unions put 33 per cent of all shareholder motions (926 out of 2,819) via union funds (Renneboog and Szilagyi 2008). Pension funds of public sector workers, by comparison, put only five per cent and SRI investors four per cent of motions. The most successful motions were those that spoke out against anti-takeover provisions. However, motions in the United States, in contrast to Europe, are not binding.

For activities within the framework of pension fund engagement as a rule agreement with the employers is required, as they have a say in the management of the pension fund. On top of that, investment is mainly

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4. FairPensions is an NGO founded in 2005 with the aim of promoting responsible investment on the part of pension funds.
outsourced to investment funds who exercise the voting rights. Clear guidelines must be given to the funds to direct their voting behaviour.

The shares held by pension funds in individual companies are much too low – in order to spread investment risk – to be able to exert a decisive influence. Thus funds in which trade unions are involved are dependent on alliances with other institutional investors. This can be best achieved with corporate governance issues. There can also be constellations in which there is a coalition of interests against the management. But such alliances scarcely emerge when the focus is ‘labour issues’, such as preventing discrimination and similar matters.

Sometimes, pension funds can put effective pressure on a company even when their shareholding is small. Thus the Californian pension fund for public sector workers CalPERS, which had a small shareholding in Disney, could bring about the introduction of a new management by making a public issue of its weak governance. That was a kind of activism that demanded a stronger increase in the value of the company and thus criticised the management on the basis of capital-market-oriented governance.

Trade union-linked funds were the driving forces with regard to motions that sought to rein in the remuneration of CEOs. With regard to shareholder activism and engagement in the 1990s the trade unions in the United States and Canada established themselves as a significant driving force. Success has been limited, however, because motions put forward by shareholders rather than by management rarely obtain a majority. In the course of research the authors found virtually no motions related to company democratisation. There is no empirical evidence of democratisation of a company by pension funds. Companies were called upon in motions to comply with ILO core labour standards, but no motions contained calls for stronger employee influence in company decision-making processes. No allies would have been forthcoming for such motions among the other shareholders. In contrast, numerous activities can be found directed towards obtaining more shareholders’ rights, and sometimes these are successful.

The attempt to establish a long-term perspective on the financial markets ‘from within’ has thus far had a limited effect. There have been motions supported by the AFL-CIO to the effect that the management should hold its shares in the company until retirement, that there should be waiting
periods for bonuses or that share packages as part of management remuneration packages can be earned only after a particular period of time. However, such motions were unable to achieve majority support. The most support was obtained for motions on the individual election of directors.

The difference between ownership and control of capital has to date been resolved only to a limited extent. Progress has been made to the extent that in the United States and Canada investment managers have to disclose their voting behaviour and sometimes receive directives for exercising voting rights. Where in the United States there are separate votes for union funds this takes place in close agreement with trade union voting directives. This shows that in many funds it has been possible to obtain control over how the managers exercise the voting rights of workers’ pension capital. However, there is still some way to go to disseminate this practice further.

Strategies for using pension capital to a greater extent in the interests of employees depend on a favourable political climate and legal framework. This is shown, for example, by funds for public sector workers in the United States, whose boards are staffed by the relevant administration. The Republican administration in California ended the pronounced (trade union-friendly) activism of CalPERS in 2004. CalPERS both excluded a number of countries and branches from its investment universe and was also a very active shareholder in conflict with the management of many companies.

A narrow definition of trustees’ duties can hinder the exercise of voting rights and application of non-financial investment criteria because trustees fear that this could contravene their duties. Another field of action for the trade unions, accordingly, would be to bring about a change in the regulatory framework. If one considers the number of shareholder motions that have successfully been brought against the management and voted on one could reach the conclusion that the strategy of trying to influence companies through the exercise of voting rights has failed. However, the success of engagement cannot be measured solely by the approval of shareholders’ motions at general meetings because many matters are successfully dealt with at an early stage in cooperation with the company and motions are put only when the company ignored suggestions.
In Switzerland, Novartis can be taken as an example. In 2010 motions on ending the dual function of chairman and CEO at the head of the group and on consultative votes on managers’ remuneration were withdrawn after Novartis agreed in advance to comply with the demands. From Canada, SHARE reports that at the beginning of 2010 80 per cent of interventions in companies were successful. Successes may also be noted from Switzerland with regard to engagement and the exercise of voting rights within the framework of the Ethos campaigns ‘Say on Pay’ and ‘Stop Chairman-CEO’. In these cases it was not a voting majority that forced a change in behaviour but the pressure on the company in the public debate, the (announced) shareholder motions and the relatively strong agreement that brought it about.

Among other things, differences in national legal frameworks and in the provisions on corporate governance of individual countries are seen as a problem area for the effective implementation of engagement in its numerous varieties. These things hinder a consistent and coherent policy on exercising and delegating voting rights. Another problem is the complexity of investment chains, tied to the problem of representation with regard to the direct ownership of securities and the decoupling of prospective beneficiaries from investment decision-making. The role of consultancy firms is also sometimes characterised by conflicts of interest. Pension funds’ engagement is concentrated mainly on domestic companies, but large parts of portfolios are invested in foreign companies. Many fund managers decidedly prefer investments abroad because they do not run the risk of getting on the radar of local media which reports, for example, on how private equity funds treat the employees and whether there are job losses.

7. Voting behaviour of investment managers

Most pension funds invest in investment funds. These then exercise the voting rights attached to the shares. However, investment managers can be given guidelines for voting behaviour and required to provide reports on voting behaviour.

The trade unions in the United States, Canada and the United Kingdom try to achieve more transparency by campaigning for mandatory disclosure of voting behaviour by investment managers. Furthermore, they analyse voting behaviour and evaluate which investment managers vote in compliance with trade union principles and which ones do not.
Many investigations of the voting behaviour of investment managers in the United States, Canada and the United Kingdom show that these managers often deviate from trade union concerns.

The AFL-CIO analyses the extent to which investment funds vote in accordance with AFL-CIO principles. Funds are ranked in three groups:

1. The best group comprises managers whose voting behaviour exhibits 100 per cent agreement with AFL-CIO principles and have voted on more than five motions;
2. The middle group comprises managers who have voted on more than five motions and show between 50 per cent and 100 per cent agreement;
3. The lower group comprises managers who have voted on more than five motions and exhibit below 50 per cent agreement or do not disclose their voting behaviour.

If one looks at the relative distribution of managers in the three groups over time it turns out that they are concentrated in the middle group and that the number of funds that provide data is on a downward trend (see Table 1).

Table 1  Distribution of Investment Managers by accordance to AFL-CIO principles, 2006-2010

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Best</td>
<td>40</td>
<td>31</td>
<td>27</td>
<td>30</td>
<td>29</td>
</tr>
<tr>
<td>Middle</td>
<td>58</td>
<td>60</td>
<td>52</td>
<td>38</td>
<td>52</td>
</tr>
<tr>
<td>Lower</td>
<td>24</td>
<td>20</td>
<td>23</td>
<td>18</td>
<td>15</td>
</tr>
<tr>
<td>Total</td>
<td>122</td>
<td>111</td>
<td>102</td>
<td>86</td>
<td>96</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Relative distribution</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Best</td>
<td>33%</td>
<td>28%</td>
<td>26%</td>
<td>35%</td>
<td>30%</td>
</tr>
<tr>
<td>Middle</td>
<td>48%</td>
<td>54%</td>
<td>51%</td>
<td>44%</td>
<td>54%</td>
</tr>
<tr>
<td>Lower</td>
<td>20%</td>
<td>18%</td>
<td>23%</td>
<td>21%</td>
<td>16%</td>
</tr>
</tbody>
</table>

Source: AFL-CIO (several years), authors’ calculations.

The US trade union AFSCME\(^5\) (American Federation of State, County and Municipal Employees) participated in an analysis of the voting behaviour

\(^5\) By its own estimate, the AFSCME has 1.6 million members who work primarily in the public sector and in health care.
of investment funds on managers’ remuneration in 2007 and 2008. Between 2006 and 2007 the median earnings of a Chief Executive Officer (CEO) of S&P 500 companies\(^6\) rose by 23.6 per cent to 8.8 million USD. This usually happened without disagreement from the shareholders. The latter as a rule voted in conformity with the management and thus enabled excessive management pay. When individual shareholders put forth motions that contradicted management recommendations they were usually rejected by investment funds.

In 2008, management motions received 84 per cent support from investment funds on average (for comparison, in 2006 75.8 per cent and 2007 82 per cent). Shareholder motions were most successful when they favoured the approval of severance payments by the shareholders. In 2008 they obtained, on average, 69 per cent agreement and in 2007 63 per cent. In 2006 the AFSCME began to call on companies to present shareholders every year with an advisory non-binding vote on CEO remuneration. These motions for regular ‘say-on-pay’ votes received an average of 45 per cent approval (AFSCME 2008). A binding regulation of this kind in the United Kingdom serves as a model for say-on-pay votes. In the United Kingdom, a remuneration report has had to be produced and voted on since 2003. From 2003 to 2011, however, only 18 such reports were not accepted (Williamson 2012). During the same period the ratio between CEO pay and average employee income rose from 1:132 to 1:157. Say-on-pay votes thus have not prevented excessive pay. The TUC now focuses on involving employees in remuneration committees.

An analysis by the Canadian trade union institution SHARE (Shareholder Association for Research and Education) on the voting behaviour of Canadian investment funds from 2006 to 2008 showed that, as a rule, the funds voted with the management. The management usually recommended the rejection of shareholder motions and funds approved only 7.8 per cent of these motions in 2008. In contrast, directors proposed by management received 95 per cent approval. A motion on a higher proportion of women on boards was rejected by 90 per cent of investment funds. There was little support for reducing managers’ remuneration: 80 per cent of the funds rejected a motion on sustainability criteria with regard to management pay. A motion binding

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\(^6\) The S&P 500 (Standard & Poor’s 500) is a share index based on the market capitalisation of 500 of the largest listed US companies.
voting rights to a long holding period for shares and paying higher dividends for this received only 3.3 per cent agreement. Ethical and socially sustainable funds showed much lower support for management motions and by far the highest support for shareholder motions. However, in 2008 ethical funds managed only 0.37 per cent of the assets of all funds.

Table 2  Approval rates of management and shareholder motions in Canada

<table>
<thead>
<tr>
<th>Motions in 2008</th>
<th>All investment funds</th>
<th>Ethical funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Motions by management – approval rates</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Election of directors</td>
<td>95.5%</td>
<td>49.7%</td>
</tr>
<tr>
<td>Appointment of auditors</td>
<td>99.8%</td>
<td>81.3%</td>
</tr>
<tr>
<td>Stock options, amendments to the company statutes</td>
<td>95.1%</td>
<td>58.3%</td>
</tr>
<tr>
<td>Shareholder motions – approval rates</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>7.8%</td>
<td>80.3%</td>
</tr>
<tr>
<td>Women’s quota on the board</td>
<td>9.7%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Individual election of directors</td>
<td>100.0%</td>
<td></td>
</tr>
<tr>
<td>Majority voting [1]</td>
<td>3.7%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Disclosure of participation in hedge funds</td>
<td>10.5%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Voting rights and higher dividends in the case of longer holding periods</td>
<td>3.3%</td>
<td>52.6%</td>
</tr>
<tr>
<td>Limitation of management pay</td>
<td>1.4%</td>
<td>68.8%</td>
</tr>
<tr>
<td>Non-binding vote on pay (Say on pay)</td>
<td>50.8%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Taking into account environmental and social factors with regard to management pay</td>
<td>9.6%</td>
<td>100.0%</td>
</tr>
<tr>
<td>CSR</td>
<td>20.8%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Sustainability</td>
<td>12.8%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Sustainability report in accordance with the GRI – Global Reporting Initiative</td>
<td>32.6%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Working conditions</td>
<td>11.0%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

[1] Majority voting requires that director nominees be elected by majority of votes at an annual meeting of shareholders. In many companies majority agreement is not necessary for the election of a director. In the case of the ‘plurality vote standard’ a single pro-vote can be enough in uncontested elections.

Source: SHARE (2009b), authors’ own calculations.

These results show that the investment funds rejected enhanced incentives to apply a longer time horizon for investments and the focus on short-term objectives continued. Matters backed by trade unions, such as a higher proportion of women in executive bodies, were rejected. When
investment managers vote at their own discretion they often go against trade union positions. In Canada, 67 per cent of managers did not receive instructions on how to cast their votes in 2007. Since 2006 investment managers in Canada have had to disclose their voting behaviour on the internet. The financial industry lobbied to prevent this provision.

On the basis of these assessments it is clear that, when there are specific instructions, investment managers mainly vote against trade unions’ wishes, even for capital managed for employees. Trade unions have thus – often successfully – tried to oblige managers to disclose their voting and have called on pension funds to give investment managers guidelines on how to vote. In the United States, Canada and the United Kingdom trade unions have also issued directives on voting behaviour and specific voting recommendations. At the end of 2002 the AFL-CIO lobbied the SEC successfully for a requirement that investment funds must disclose their voting behaviour.

8. **Democratisation of companies: unconvincing successes and potential solutions**

The success of the exercise of trade union influence over pension funds to democratise companies to date is unconvincing. The effect of using voting rights is limited because motions put forward by shareholders instead of management rarely obtain a majority. Michel Aglietta’s assertion that shareholders have traded control for liquidity does not apply to all pension funds. Large pension funds passively invest substantial parts of their portfolio as universal owners and thus remain long-term investors in important listed companies. They thus do not make use of the possible liquidity of their shares.

Transparency with regard to control due to share ownership has been increased through legislation. In the United States and Canada investment managers have to disclose their voting behaviour. Swiss pension funds have to set out rules on how their voting rights arising from share capital are exercised. The funds are not obliged to vote, however; this is merely a duty to make a declaration. In the Netherlands there is no such duty; the generally prominent role of SRI, however, means that some of the large funds have decided to declare their voting behaviour via their websites. In the United Kingdom, the TUC advocates that managers should disclose their voting behaviour in standardised form.
Transparency enables the trade unions and other interested parties to monitor whether voting rights are exercised in compliance with trade union directives and specific recommendations.

The trade unions in the United States, Canada, the United Kingdom, the Netherlands and Switzerland consider it appropriate to devote resources to shareholder activism and networking trustees. Even though significant impulses towards economic democracy cannot be expected to result from this, it has been a successful strategy to the extent that they have managed to increase transparency and in many funds have influenced voting behaviour. It cannot be expected that the financial markets’ inherent evaluation and orientation of company policy in terms of short-term goals can be overcome through a change in corporate governance via shareholders’ motions, however. This can succeed only when there are generally binding legal provisions ‘from outside’. In conclusion, the authors can state with regard to three countries under consideration – the United States, Canada and the United Kingdom – that the trade unions have managed to establish themselves as new actors within the framework of shareholder activism.

Capital managed and invested for employees should not be used against the interests of employees. A financial services company that manages a pension fund can achieve control over assets under management which exceed invested proprietary capital by a large factor. Thus the trade unions have begun to make efforts to control the managed capital better. The outsourcing of the exercise of voting rights to consultancy companies would make it possible to overcome the contradiction between the diversification of assets and the attempt to influence companies. If many smaller funds outsource the exercise of voting rights to consultancy companies that vote in accordance with trade union principles the limited forces of many funds could be combined. If this concentration proved possible across borders influence would be increased even further.

In order to acquire more influence trade unions and employees’ representatives have to become more active and establish themselves as actors. There are a number of possible starting points for that purpose. In the area of financial services’ duty of disclosure concerning the exercise of voting rights in (listed) companies there is a need for Europe-wide action. There is no reporting requirement in either Austria or Germany concerning the manner in which voting rights are exercised by investment companies. Thus cooperation is needed with providers that have both
capacities for research and exercise voting rights. Furthermore, directives are required that lay down positions that the trade unions can support. One ambitious idea would be to establish a proprietary (trade union) pension fund that invests in a socially responsible manner and exercises its voting rights in the interests of employees.

9. Conclusions

The analysis presented in this chapter leads to a number of conclusions:

— Within the trade union movement the idea of trade union influence in pension funds is controversial because it is sometimes construed as implying support for funded pension provision.

— Trade union influence and engagement with regard to pension funds are dependent not only on the volume of invested assets or the significance of the second pillar, but also on the organisational structure of pension funds and, in particular, the involvement of employees’ representatives.

— If the second pillar is split into many small pension funds it limits engagement activities (e.g. like in the United Kingdom).

— On the other hand, there are very large company pension funds without trade union involvement (especially in the United States) that have no engagement activities.

— In many pension funds the influence of the trade unions is only indirect because they cannot nominate board members. The trade unions try to network and support the employee trustees and to launch policy initiatives in so far as it is possible (e.g. United Kingdom and Austria).

— In multi-company pension funds in the United States the relevant trade unions face several employers, as a result of which the trade unions dominate engagement activities in these funds which are managed on a parity basis.

— The trade unions in the United States, Canada and the United Kingdom have separate departments or organisations for SRI and
engagement, as well as their own directives on voting behaviour. They issue recommendations on concrete voting behaviour at the relevant general meetings.

— The exercise of voting rights in Europe is increasing, which ultimately can be traced to initiatives to bundle and proxy voting. Overall, in the case of European pension funds, this remains at a much lower level than in the United States. Different country-specific regulations on shareholders’ rights complicate engagement in Europe.

— Shareholder motions seldom achieve a majority in North America either. However, putting forward a motion or threatening to do this often brings about a change in behaviour. Successful shareholder motions within the framework of campaigns conducted in several countries include the ‘say-on-pay’ initiatives concerning management salaries or initiatives against the accumulation of positions in company management.

— In the United States and Canada trade unions have managed to improve the transparency provisions with regard to investment funds. Since 2003 in the former case and 2006 in the latter case these funds have had to disclose their voting behaviour. Where there are separate votes for union funds this takes place in close agreement with trade union voting directives.

— The Committee on Workers’ Capital as an international initiative serves the purposes of networking and exchange of information. However, the level of awareness of the CWC’s work must be boosted in individual trade unions.

— Trustees’ duties limit the options both for engagement and for the selection of SRI portfolios because all actions must serve the exclusive purpose of being in the interests of beneficiaries as future pension recipients. This leads even employees’ representatives to caution with regard to SRI, where this is legally permissible. The engagement activities of the trade unions are thus launched mainly on the basis of issues of corporate governance, even if other reasons may have led to dissatisfaction with the management. On one hand, such motions are compatible with trustees’ duties; on the other hand, such issues are also more suited for forging alliances with other investors.
— The training of trustees is a key issue. It is thus important how one reaches the individual trade unions. The necessary infrastructure is key to making contact and exchanging views and information.

— Although a tendency on the part of engagement activities towards a democratisation of company governance is discussed in theory, there is no empirical evidence for it. Trade union funds also strongly favour shareholders’ rights, even when this comes into conflict with the interests of the employees of the company (for example, anti-takeover provisions).

— The transaction costs of exerting influence are enormous. The trade unions need expertise in trade union law (international!), securities law and so on. Only a few trade unions have the relevant resources and do this ‘in-house’.

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Chapter 6
Workplace rights and sustainability reporting – is the workforce a well-informed stakeholder?

Jan Cremers

1. Introduction

This chapter focuses on the current state of workplace rights in Europe to information on different dimensions of sustainability, including social and environmental aspects. This is an important issue since the workforce must be adequately informed about these issues to exercise effective ‘voice’ in corporate governance and company affairs in support of long-term sustainable investment. To summarise, workplace rights to sustainability information vary greatly from country to country in Europe, but on the whole these rights are not adequate to ensure that workers are a well-informed stakeholder.

Transparency in reporting and open-minded communication are central elements of the Sustainable Company (Vitols and Kluge 2011; Hojnik 2012). As such they can be important elements of a company’s social policy. These activities contribute to a positive image and demonstrate that social responsibility is not just lip service paid to international standards or theoretical codes. Non-financial reporting to the workforce on sustainability-related issues can help to demonstrate that shareholder value is not the sole concern and that a committed workforce is a key objective of the company’s policy. In this respect, at least three dimensions of non-financial reporting can be defined:

(i) The use of a clear normative framework. The normative framework can have a legal background, but can also be of a voluntary nature. Reference to (and practical use of) this framework deals with the question: is reporting based systematically on existing fundamental principles related to an information and consultation policy which take into account the requirements of social and sustainable coherence, or is it oriented to image building and the opportunistic daily rate of ‘marketing’ values?
(ii) The social dimension of sustainable development in practice. Are any production- and work-related sustainability goals made operational (e.g. connected to work environment, health and safety of users and workers, life cycle and waste)? Formulated in a broader sense this is also related to HRM policies in the field of training and retraining, innovation and obtaining further qualifications. In essence, it concerns the question of how to make and keep the workforce fit for the challenges connected to a more sustainable company policy.

(iii) The broader productive environment and its impact must be taken into account. This is not only about pollution and the use of (non-) renewable sources but also about liability for sustainability issues further down the chain of production, including outsourcing, subcontracting and supply.

At the end of 2011, in a survey dedicated to workplace information, consultation and codetermination rights, the SEEurope network looked into the existing legal framework and the practices of non-financial reporting on sustainability-related issues. Based on the input of the national experts of the network a Europe-wide overview was produced (Cremers 2013). This chapter explores the outcome of that exercise.

According to some authors, the road towards reporting is just as important as the actual reporting (Oxford Research 2003). Therefore, this chapter starts with a summarised overview of the existing reporting frameworks in the countries included in the inquiry. The second section is dedicated to the relationship between ‘usual’ subjects of social dialogue and aspects of sustainability, followed by a section on internal and.

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1. SEEurope is a project conducted by an international network of researchers under the leadership of the ETUI. The project, which started in 2004, began by observing the transposition into national law of the European legal obligations related to the Regulation on the Statute for a European Company (SE). In the SEEurope inquiry dedicated to workplace information, consultation and codetermination rights on sustainability issues, the SEEurope network produced a first overview of the existing legal frameworks and the current practices of non-financial reporting on sustainability-related issues in different European countries. The resulting Europe-wide overview was based on the input of the experts of the network (26 Member States plus Norway and Switzerland). The national experts, all committed network partners, were asked to report along the lines of an open list of items. The topic of the inquiry was to analyse company policies in the area of sustainability-related issues and reporting to the workforce in different European countries. This resulted in country observations prepared by the experts.
external reporting. The role of trade unions is sketched out, followed by some practices that are worth mentioning. In the final part the results of this exploratory research are summarised.

2. **Reference to workers’ representatives and sustainability reporting**

The SEEurope investigation pinpointed a few indicative items related to the relevance of non-financial reporting on sustainability related issues in Europe. It was a first exercise designed to go beyond the superficial registration of official and abstract declarations. The results were summarised in a report divided in five sections, followed by a concluding part that reflects on the incidence of this type of reporting and on various challenges, including the future role of the trade unions in this debate. The starting point of the reporting task was to map the normative framework, i.e. the legal or conventional rights of workplace representatives to information, consultation and codetermination on sustainability-related issues in various European countries. The experts were asked to summarise the legal rights of workers’ representatives in their country to information, consultation and codetermination specifically related to issues such as training, skills and workforce development, labour force characteristics (turnover, diversity, age distribution), health and safety, environmental impacts and risks, as well as outsourcing and supply or production chain management (including environmental and social standards in the supply chain).

The focus was thus on the normative framework formulated with guidelines regarding contents, structure and process in connection with the preparation of reports and accounts that give information on more than just the financial status of the company. These reports may include very diverse descriptions of non-financial assets.

The normative framework for non-financial reporting that was sketched out in the contributions had various forms. The regulatory frameworks for industrial relations and the labour market traditions in European countries are also different in this regard. In a very general way it is possible to distinguish between four types of norms related to non-financial reporting:
(i) norms that can be derived from legislation, with either a mandatory or a non-binding character;

(ii) norms based on corporate governance and/or corporate social responsibility codes and principles, which are almost always of a voluntary nature;

(iii) norms formulated in collective agreements between social partners, with compliance a task for the contract partners, depending to a great extent on the discipline and strength of the partnership; and

(iv) norms settled in individual companies through company agreements, international framework agreements, codes of conduct and the like, either with different signatories (workers’ representatives, works councils, trade unions, European or global unions) or unilateral.

It is not an easy task to summarise the findings in the field of the legal framework that exist in the 28 countries that were involved in the inquiry. The overall picture is rather diverse. With some exceptions non-financial reporting does not belong to the core of the workers’ rights enshrined in legislation or codes. The most outspoken policy area with references to non-financial reporting regards social legislation. Surprisingly, existing national environmental legislation is rarely referred to in the reporting rights of workers, apart from the often stringent rules for the handling of chemicals and carcinogenic and other toxic substances. Notwithstanding the diversity that can be seen, some types of norms in this area are more developed than others.

Although a wide range of information and consultation rights exists in the countries examined, the common denominator is that workers representatives and/or trade unions are entitled to obtain general information and to be consulted on the company’s activities, future strategies, environmental impact and sustainability related measures. In general terms, information and consultation appears in various forms prescribed in a set of regulations of a legal and/or conventional nature. The framework for information and consultation rights covers a wide range of subject matters (e.g. qualifications, labour force characteristics, health and safety, outsourcing, gender-related pay). To just give a few examples: in France workers representatives have the right to be informed every three months about the monthly composition of the
workforce, in particular by type of contract (fixed, temporary, agency work, part-time, outsourcing, apprenticeship and so on), including reasons for any hiring on a contract basis. Works councils can appoint an expert paid for by the company to examine the annual economic report, in case of dismissals for economic reasons or in case of important technological changes. The expert shall have access to the company and its documents. German works councils have the right to submit proposals on a broad range of items, including job security, new forms of work organisation, qualifications, outsourcing and investment plans. Rights in the area of health and safety at work and involvement with environmental protection in the establishment often go hand in hand. This includes the right to take part in inspections, the monitoring of compliance with accident prevention and environmental protection. Works councils in the Netherlands have a general right to initiate consultations on relevant issues (Art. 23 and 24 of the Works Council Act) and a right of initiative with regard to sustainability issues. Spain’s Workers’ Statute (1980, adapted in 1995) entitles workers and their representatives to information on a quarterly basis about environmental decisions taken by the firm with an impact on employment.

The legal instruments for these rights are grounded in some countries in national information and consultation practices, and in other countries these rights are mainly the result of the transposition of European Council directives and European framework agreements signed within the context of the European social dialogue. In addition to this Labour Codes, Labour Constitution Acts, Industrial Relations Codes and the like sometimes refer to this type of right. Companies have to provide workers representatives with certain non-financial data, such as information on strategies, organisation, prospects and operations, paying particular attention to employment issues. However, most countries have no specific rights defined in relation to sustainability and environmental issues; these issues therefore do not figure prominently on the agenda that can be derived from the information and consultation provisions.

Secondly, some countries also have rather extensive participation and co-determination rights. Based on these rights workers’ representatives have the right to receive all relevant information in a company. Through these further-reaching codetermination and participation rights in the supervisory board, in principle all questions regarding the company can be addressed to the CEO. Based on the general supervisory tasks of the supervisory board in Germany’s codetermination system, worker
representatives on the board have the right to discuss most of the items (for example, health and safety, workforce development, labour force characteristics, risk management and environmental risks), as these items are subject to regular reporting in the supervisory board. The supervisory board can address compliance with CSR or other guidelines. Sustainability-related issues, such as financial sustainability or energy efficiency, can be part of the board’s strategic planning tasks. For example, energy costs can be a prominent factor in production costs and in sectors like steel production might even exceed personnel costs. Thus, focusing on energy costs in the supervisory board might reduce the pressure on personnel costs. Article 4 of the Act on Workers’ Participation in Management (AWPM) in Slovenia states that the right of workers to participate in management individually and collectively may be exercised in particular in making decisions about and influencing plans regarding work organisation and in the determination and implementation of activities designed to improve working conditions, humanise the work environment and encourage successful economic performance.

A third component of social legislation that has some links with non-financial reporting is legislation on health and safety at work. Especially in countries where this policy field has been progressively developed into a broader concept of a safe ‘work environment’, information and consultation rights sometimes have expanded in a sustainable direction. For example the Belgian safety committee for prevention and protection at work must take a position with regard to the annual environmental report that every major company has to establish. The committee also has a controlling function; general consent is required for the hiring, appointment or replacement of an internal prevention advisor (a knowledgeable collaborator of the safety and health department) and for the environmental coordinator (who can be an in-house professional or an external expert). The French committees on health, safety and working conditions (CHSCT), legally introduced in 1982, have the right to conduct inspections and investigations. If an establishment is classified as having environmental risks, the information and consultation rights of the CHSCT are extended to cover this type of risk. In Ireland a wide range of occupational health and safety and dangerous substances legislation and associated codes of practice are administered and enforced, in whole or in part, by the Health and Safety Authority. Works councils in the Netherlands have extended rights of information and consultation in the field of health and safety when the employer intends to take measures related to the environment. In many cases this will be part of investment
decisions, on which the works council also has a right of consultation. When the employer does not follow their advice and there is conflict, the works council may go to court to challenge the decision. Poland’s environmental legislation states that an operator of an establishment that presents a high risk to the environment must provide an opportunity to be involved in proceedings to employees directly exposed to the effects of industrial accidents, as well as to social work inspectors and representatives of trade unions responsible for occupational safety and health. Certain aspects of sustainability, such as emissions policy or control, can be dealt with in Switzerland on the basis of health and safety regulations. In the United Kingdom, safety representatives are entitled to full information from their employers to enable them to carry out their functions involving changes that may affect workers’ health and safety, hazards and prevention, occupational diseases and health and safety statistics. Along the same lines, safety representatives should be consulted in good time about the introduction of measures or new arrangements that affect health and safety, necessary training and introduction of new technologies.

In addition to inclusion in social legislation some countries have non-financial reporting duties enshrined in their company legislation. Regulations sometimes refer to mandatory ‘social’ or ‘environmental’ audits and accountancy rules that include sustainability reporting. Some legal specificities are worth mentioning. The Austrian legislator has implemented EU Directive 2003/51 EC in the Company Act (Unternehmensgesetzbuch). It prescribes that annual reports and consolidated annual reports should not be restricted to financial aspects. Pursuant to §243 (5) annual reports must include non-financial performance indicators, with specific mention of environmental and employee matters. In Belgium, the legal framework for the federal coordination of sustainable development formulated in the Law of 5 May 1997 led to the foundation of the Belgian Federal Council for Sustainable Development (FRDO-CFDD). Requirements for companies to provide non-financial information are mostly laid down in the regulations on company accounting; enterprises make public certain elements of non-financial data via their annual report. On top of that, companies have to provide information on social policies by means of the so-called ‘social audit’. Surprisingly, the social balance concept did not originate from the traditional consultations between employers’ and trade union organisations: this legislation was rather a pro-active initiative of the federal government. In France the law prescribes that companies with
more than 300 employees must present an annual social report (‘bilan social’), including a broad range of items. The works council is consulted on the content; trade unions, the labour inspectorate and individual employees who ask for it shall receive copies. The Grenelle II law of July 2010 extends the external social and environmental reporting obligation from listed to other big companies.

The findings in the field of norms based on corporate governance and/or CSR codes lead to the conclusion that the current regulations derived from the mainstream codes grant employers considerable liberty to determine which non-financial information is relevant to stakeholders. In countries like Bulgaria, where the debate on sustainability issues is still in its initial stages, most companies – even those that have accepted the National Code for Corporate Governance – prefer not to disclose information, especially concerning environmental issues, health and safety at work or strategy and marketing. At the other end of the spectrum one can find countries like Germany or France. The five French union confederations participated together with a series of companies, employers’ organisations, investment funds and NGOs in creating a CSR Observatory (ORSE) in June 2000. The reporting regulations are summarised on the ORSE portal, which is available in French and English. The German unions were involved in the extensive general debate on sustainability that led in 2011 to a new voluntary sustainability code (the Nachhaltigkeitskodex). The code that was formulated in line with existing international reporting standards (UN Global Compact, ISO 26000, GRI, EFFAS) follows the comply-or-explain principle similar to the corporate governance code, but is not binding (Der Rat für Nachhaltige Entwicklung 2012). Although workers are defined in this Kodex as stakeholders and therefore can derive general dialogue and information rights, the paragraphs on workers’ rights mainly describe traditional rights (on labour standards, equality in the workplace, employment, health and safety). The German Corporate Governance Code explicitly favours the stakeholder approach, with a clear long-term focus. In its preamble, the Code clarifies the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and sustainable value creation in conformity with the principles of the social market economy. Works councils in the Netherlands have legal possibilities to render advice with regard to

2. See www.orse.org
sustainability and reporting on (international) CSR. The important Swiss framework of corporate governance and CSR codes has led to another type of reporting. However, there is no direct reference to workers’ representatives or trade unions. The main channel through which sustainability is presented in the UK is corporate social responsibility (CSR) reports, which most large companies produce. However, they do not normally deal with issues of employment and workplace conditions, other than to try to get employees to actively support other CSR goals.

Norms for non-financial reporting can be the subject of collective bargaining. This is sometimes the case in the Nordic countries, but also in other countries trade unions can have the right to negotiate parameters of working conditions that go beyond working time, working environment and health and safety. However, environmental issues can often be tabled only as far as they concern health and safety at work or working conditions in general. It is noteworthy to mention that the Industrial Relations Code in Cyprus, which dates back to 1977, is not part of the legal framework, but is based on an agreement between the social partners. However, there is no reference to non-financial reporting in this Code and there is little room in the voluntary context for information and consultation or codetermination on sustainability-related issues. In Denmark the social partners (trade unions and employers’ organisations) have entered into cooperation agreements which, besides regulating general cooperation, also regulate the rights and duties of employees and companies with regard to information and consultation rights that include questions about education, training, the development and quality of the labour force and outsourcing. Concerns about sustainability are often expressed in terms of competitiveness and discussed with the trade unions in relation to efforts to maintain a well-qualified workforce or to introduce new systems of production (lean production, for example). Although sustainability belongs to the hard core of recent debates in Luxembourg on wage setting arrangements, it has not had a substantial effect on reporting policy.

Norms on non-financial reporting that can be derived from company agreements are rather rare. A specific form of representation at company level is the Italian Unitary Workplace Union Structure (RSU) with general competences, such as the economic situation, employment structure and substantial changes, and specific arrangements that are the result of bargaining. Sustainability issues are seldom a subject of these agreements. In Norway, employees at company level are represented by
local trade unions, with competences and rights enshrined in basic collective agreements. Regulations laid down in the agreements are binding for the company (if it is a member of the employers’ association) and for the trade union representatives. The agreements set the rules for collaboration at company or group level with different definitions of information, consultation and negotiation rights. In recent agreements the enterprise’s influence on the external environment and a decent and sustainable working life are formulated as important concerns. There is a long list of items with regard to which information and consultation rights apply, including various sustainability-related items, both internal – for example, recycling, use of electric cars and so on – and external, related to products or the production process as such. According to Sweden’s 1977 Work Environment Act the employer and employees cooperate on working environment issues; in this field the workers’ representatives have to heed the interests of all employees, including members of other unions and non-organised workers.

3. Social dialogue and non-financial reporting

According to EU Directive 2003/51 EC, annual reports and consolidated reports should not be restricted to the financial aspects of a company’s business. For an understanding of the company’s development, the analysis has to include ‘non-financial key performance indicators relevant to the particular business, including information related to environmental and employee matters’ (European Parliament 2003). The bridge between the ‘usual’ subjects of social dialogue and aspects of sustainability is interesting, notably with reference to the social dimension of sustainable development in practice. The implicit question is whether any production and work-related sustainability goals are formulated and reported on in the traditional areas of workers’ representatives’ concerns, such as work environment, health and safety of users and workers and life cycle and waste. Formulated in a broader sense this can be related to HRM policies on training and retraining, innovation and further qualification; in other words to policies that serve to make and keep the workforce fit for the challenges connected to a more sustainable company policy.

The number of published reports is slowly but constantly growing and in countries such as Belgium, Germany, France, Austria and the Netherlands reports are now produced by all types of organisations, from
private to public companies, and also not-for-profit organisations; however, non-financial information addressing both shareholders and other stakeholders is often limited to risks and uncertainties with which the company might have to cope. Sustainability reporting continues to be a management prerogative and part of a unilateral process. With some aspects (health and safety, energy conservation, emissions and saving programmes) having been regulated the reporting landscape remains rather patchy. Even in a country such as Austria, with legislation that can serve as a guideline for non-financial reporting, and with institutions such as the Chamber of Labour that have the capacity to monitor such voluntary, non-binding guidelines, workforce and workplace conditions are not seen as a key part of sustainability. In the field of codetermination on working conditions fewer than 10 per cent of companies gave full or at least partial information. Items going beyond the workplace were not reported at all, not to mention sustainability issues.

To the extent that dialogue takes place at all it is mainly in the form of dialogue at national level (or in some countries at sectoral level) in round tables or meetings of national Economic and Social Councils and other national bodies related to CSR policy. In Belgium, for instance, two important social dialogue bodies situated at the federal level – the Central Economic Council and the National Labour Council – in which trade unions play an important role, had a joint discussion in 2006 on the notion of enterprises’ social responsibility, a debate closely related to sustainability. The social partners underlined that this concept goes far beyond mere adherence to regulatory requirements and includes investment in human capital, in the environment and in relations with all stakeholders. However, there has not been a direct effect on either non-financial reporting or dialogue at company level in this area. Latvia has a Sustainability Index, within the framework of which companies are assessed according to a number of criteria, including safety at work and workforce conditions, in order to be recognised as sustainable economic operators and employers.

In the most obvious cases issues of non-financial reporting and sustainability are being approached in connection with corporate social responsibility policies. Non-financial reporting is seen as a way to develop this responsibility. It is noted that the existing good practices related to the Stock Exchange, for instance in Poland, do not refer to employees but focus on the needs of shareholders. In the Czech Republic individual businesses have launched websites that provide information about
sustainability-related issues and other promotional materials. Partly, these initiatives are in line with the EU’s promotion of CSR and the work of the European Business Network (with comparable initiatives in other countries, such as Greece, Slovenia, Romania or Portugal leading to CSR networks and portals); partly, the sites are run by commercial consultancies. Scarce evidence and a lack of relevant research does not allow us to assess the extent to which, in practice, improving workplace conditions is seen as a key part of sustainability. The general impression is that CSR reporting is on the rise. An increasing number of – mainly large – companies in Italy carries out sustainability reporting, while small and medium-size companies are more likely to adopt some CSR without reporting on their application. Romanian figures indicate a substantial increase in reporting (from 24 per cent in 2008 to 54 per cent in 2010), motivated by ‘brand reputation and economic considerations’.

The French public debate and public opinion, which called for stronger regulation of companies’ activities, led in 2001 to a law on ‘new economic regulations’ which contains an obligation for social and environmental reporting for listed companies. France was the first European country to adopt this type of legislation. Greece has over the past decade launched initiatives and activities on what is called ‘sustainability or non-financial reporting’ as part of debates on corporate governance and corporate responsibility. But research between 2002 and 2006 does not indicate substantial growth in published non-financial reports; a limited number of companies are compiling sustainability reports, but there are significant gaps in practice. In the Netherlands, sustainability is a regular issue in the Social and Economic Council (SER). Recently (2011 and 2012), works councils in multinational enterprises have devoted much attention to the issue. Currently, the role of works councils with regard to sustainability and reporting on (international) CSR is the subject of political debate. During the Polish EU presidency in the second half of 2011 several examples of CSR practice were presented at an international CSR conference. Among the reports was an interesting case of non-financial reporting described by a representative of the LOTOS group (Twardowska 2011). In the presentation of this case the barriers to sound

3. In 1994 a group of European entrepreneurs and business directors signed the European Declaration of Business against Social Exclusion, as a result of which the European Business Network for Social Cohesion was created in 1995. One of the key objectives was to support the creation of corresponding National Networks.

4. As an example see: http://www.csr-romania.ro/english.html
CSR reporting were listed, including: limited awareness of the concept and related reporting, reports treated as PR tools, lack of openness in the communication of difficult issues and restricted resources and limited access to data. The United Kingdom had extensive debates about sustainability in companies, the main channel being corporate social responsibility reports, which most large companies produce. However, they do not normally deal with issues of employment and workplace conditions, other than to mobilise employees to support other CSR goals.

Reporting to the workforce with the explicit aim of building bridges between ‘ordinary’ workplace-related issues and sustainability goals happens only where there is pressing need. For instance, in Bulgaria environmental issues are discussed mainly with workers’ representatives when serious problems exist and where EU standards should be implemented or improved. One traditional aspect frequently discussed is the quality of the workforce, which in many countries is linked to debates on lifelong learning. The observation was made in several countries that these deliberations are dictated mainly by concerns of labour market friction. Non-financial reporting is too often an internal management affair; involvement of workers’ representatives is rare and if it happens it is in the context of the work of EWCs. For the rest reference is rare to issues related to workforce and workplace conditions in sustainability reports. In the 70–80 Greek companies in which sustainability reporting is practiced there is no evidence of a move from traditional concerns of workers’ representatives to more ‘universalistic’ concerns with sustainability.\(^5\) In the Netherlands no research has been conducted on the ‘real’ impact of sustainability practices on the workforce. There are reports by individual firms on (supposed) effects on absenteeism due to sickness, labour participation of disadvantaged groups, health and safety (number of accidents), satisfaction of employees with their job and so on, but not at the macro level. One link reported in Denmark concerns worries about financial sustainability and competitiveness. Although questions concerning payments are included, the real issue is how to maintain a well-qualified labour force.

Remarkable in this context is the finding in Sweden that there has been practically no debate concerning the sustainability of companies within Swedish borders; the view is more how companies should behave abroad.

\(^5\) Sustainable Development Ltd (www.sdev.gr) has developed a database with Greek CSR Reports.
The Norwegian debate on CSR also focuses on the behaviour of companies abroad (for example, the most extensive green paper on social responsibility was issued by the Ministry of Foreign Affairs). An interesting initiative has been launched in Slovenia: the project Family-Friendly Enterprise Certificate is aimed at introducing work-family life balance as an issue to be discussed at the workplace. The Horus award, another initiative in Slovenia, aims to promote integrity in thinking, innovation and accountability in the operations of Slovenian companies. The award seeks to promote awareness of the importance of social responsibility and has become the leading award in the field of balanced and innovative social responsibility. Horus is open to small, medium-size and large businesses and institutions engaged in any activities and projects aimed at the long-term welfare of employees, the environment, communities and customers which exceed the minimum statutory standards for at least one year; these can therefore be considered socially responsible, regardless of whether the efforts have formally been approved by certificates, prizes or awards. Polish trade union Solidarność has introduced its own label ‘Przyjazny pracodawca’ (Friendly employer). Its main characteristics are: priority given to open-ended employment and compliance with labour law and trade union rights. Legislation in Spain entitles workers’ representatives to information on a quarterly basis on environmental measures taken by firms with an employment impact. This is aimed at getting workers on board with regard to environmental sustainability in cases when there is explicit reference to this goal.

Before the crisis, political and socio-economic reflections on climate change and, both at national and European level, on ‘fair’ and ‘green deals’ raised expectations of a broadening of company policies. However, our blunt conclusion is that, in the majority of the European countries, not enough ground has been gained. To summarise the findings:

(i) In a group of countries there is a complete standstill. As a consequence, the debate about sustainability and impacts on the workplace and workforce conditions is rather theoretical.

(ii) There is hardly any evidence of non-financial reporting by individual companies in the past decade that goes beyond the ‘traditional’ items. The legislative focus is generally on employment

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6. The annual call for applications is also available in English: http://www.horus.si/images/2011-call.pdf
security, health, training and the provision of economic data and management issues. There are no empirical data to verify the extent to which these issues are being further developed.

(iii) Workforce and workplace conditions are not seen as a key part of sustainability. An exemplary finding was a Swiss transnational company ranked in the Dow Jones Index at the top of the sustainability ranking even though it does not take into account working conditions or work environment issues.

(iv) CSR is on the rise, but partly due to the crisis, and partly due to the fact that unions are on the defensive, the role of workers’ representatives and their organisations is still in its infancy. Recognition of the crucial role they might play cannot be the result of a free ride.

The debate on the concepts of corporate social responsibility (CSR), sustainability and stakeholder value has become of particular interest among politicians, the public and the corporate sector in Europe since the end of the 1990s; however, reporting with accounts in which environmental, social and economic indicators are combined with a view to illustrating the work environment and the influence on the surrounding society is still in its infancy. Even in a country such as France, with extensive legislation and stakeholders’ rights, non-financial reporting does not play an important role in the dialogue with those stakeholders, including employees’ representatives. However, some promising initiatives do exist, as detailed in the following sections.

4. Internal and external reporting

Internal reporting is supposed to provide key internal stakeholder groups with information on progress, successes and challenges to ‘help maintain commitment and reinforce ownership’ (BMA 2011). The nature and timing of internal reporting will depend upon governance structures, the key stakeholder groups with which communication is planned, internal communication procedures, data availability and the resources available to compile reports. Accurate and honest reporting to an external audience on the organisation’s activities and performance can be a powerful tool for strengthening dialogue, engendering trust and demonstrating leadership (Sustainable Procurement Task Force 2006). Several
reference methods exist, such as ISO 26000, the standard on social responsibility. This standard offers guidance on socially responsible behaviour and possible actions. It does not contain requirements and, therefore, in contrast to ISO management system standards, is not certifiable. For the time being, it can be used only as a self-assessment tool. Various useful reporting frameworks also have been developed for sustainable development and environmental reporting, such as the Balanced Scorecard derived from ISO9000, the AA1000 Accountability Assurance Standard\(^7\) or the Global Reporting Initiative – Sustainable Reporting Guidelines.\(^8\) First, the role of workers’ representatives in the development of reporting systems will be treated. The next section is dedicated to the involvement of trade unions in debates on strengthening external non-financial reporting, for example through a mandatory requirement for companies or an extension of the items on which they should report.

It was already mentioned that there is little specific reporting to workers and their representatives. The ETUC statement might be correct that there is reason for concern, against the backdrop of the financial, economic and social crisis, the dominance of neo-liberal policies and heightened competition, that ‘more European companies will consider CSR to be a “luxury” and will show much less respect for human rights, labour standards and environmental concerns’ (ETUC 2011). Although some scholars have come to the 'reasonable conclusion' that regulation is an effective mechanism for enforcing change in internal reporting systems and improving public reporting practices (Eccles et al. 2010) most reporting is of a non-binding character.

Given the very limited amount of internal reporting on sustainability issues it is difficult to see a link between internal and external reporting. The two cannot be inconsistent because the internal barely exists. This is not a specifically European problem; in a New Zealand survey it was found that a significant majority (83.1 per cent) of the companies that

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\(^7\) The AA1000 AccountAbility Principles were developed by a platform with the aim of aligning the non-financial aspects of sustainability with financial reporting and assurance. The intention is to give stakeholders assurances concerning the way an organisation manages sustainability performance and how it communicates this in its sustainability reporting, without verifying the reliability of the reported information. See: http://www.accountability.org/standards/aa1000as/index.html, AccountAbility (2008).

\(^8\) The Global Reporting Initiative has pioneered the development of the world’s most widely used sustainability reporting framework: https://www.globalreporting.org/Pages/default.aspx
responded to the survey had not asked stakeholders in the past five years whether they would like to receive more information on the company’s environmental and social performance (Eccles et al. 2010: 246). Second, even in countries with developed CSR and corporate governance practices, overall compliance with reporting is still not particularly good, at least from a European perspective, although significant differences exist. And third, if reporting takes place it is mainly addressed to the market and to shareholders. Although case study evidence shows that workers’ representatives expect more and/or earlier information than what is provided to the shareholders and the general public, it is a common complaint of representatives that they receive just the information that has already been made public. Qualitative research results on the impact of sustainability reporting on working conditions are scarce. Most research projects are oriented to analyse the relationship between CSR and financial performance.

As a result, the analysis in this section is relatively short:

(i) There is a category of countries in which no significant reporting can be found. Findings about reporting in practice hardly exist, and one could say that there is no substance beyond the theoretical ‘lip service’ formulated within the normative framework described earlier on. This is the case in, for example, Lithuania, Latvia, Hungary, Estonia and the Slovak Republic.

(ii) In a second category of countries, reporting is mainly restricted to financial and economic matters. In these countries, workers’ representatives receive the same information that is given to the public through annual reports, website information and announcements to shareholders. In some cases, selected parts of this information are provided and exchanged at works council meetings (usually EWC meetings).

(iii) In some countries, a substantial proportion of the reporting is dedicated to social policy and CSR. Again, there is normally no difference between reporting to the general public and to workers’ representatives and there is hardly any interaction between social policy and the sustainability dimension. Sustainability issues are treated as concerning external effects of the company on, for example, the environment or the community. Sometimes an overlap can be found between external and internal reporting on
social matters because of the common genealogy of the reporting indicators, next to similarities in monitoring.

(iv) Finally, in a few countries reporting goes further. According to the 2011 KPMG survey of the CSR reporting of the 100 biggest companies in each country, in 2008 France was in a leading position in Europe, just after the UK, with 94 per cent of companies reporting on CSR. But, after three years of initial progress, stagnation set in as regards reporting (KPMG 2011).

A closer look at the ‘leaders of the pack’ in the KPMG survey, from European countries that have addressed CSR and reporting for over a decade, indicates that some companies have demonstrated both strong communication and professionalism over time. In Germany, the annual report and the consolidated annual report should not be restricted to the financial aspects of the company’s business. According to German law (Sec. 289 Sub par. 3 HGB) the annual report must include non-financial performance indicators with environmental and employee matters. It is not sufficient to report only on internal business risks. Risk reporting must include external risks, for example, concerning the environment, politics, law and society. Before being published, this annual report by the management is subject to examination and discussion in the supervisory board, along with the annual financial statement. This constitutes a strong link between internal and external reporting besides the extensive information and consultation in works councils and financial committees. Furthermore, listed companies must issue a statement on the management of the company which includes information on management practices that goes beyond what the legal requirements and has relevance for the whole company. In the Netherlands non-financial reporting is said to be on the increase, especially among the largest (listed) companies, and examples of firms are mentioned (such as DSM) that have worked with different reports for different stakeholders. In some companies an effort is made to integrate notions of CSR with sustainability. In Norway reporting and information to trade unionists considerably exceeds the information made public; this may also be the case in other countries with systems characterised by strong general information and consultation rights.
5. The role of trade unions

Trade union involvement can partly be seen as a mirror of the four categories described in Section 4. Trade unions too often do not appear particularly concerned with sustainability reporting. Legislation in Lithuania refers to the obligation to include in the report of private or public limited liability company inter alia analysis of financial and non-financial results and information related to environmental issues and personnel. However, no specific rights of employees’ representatives are mentioned and the unions are not involved. The Trade Union Act in Estonia does not include specific provisions on sustainability and the unions are absent from related debates. For Cyprus it is reported that CSR and sustainability reporting have not been on the trade union agenda.

In Greece, trade unionists with some international exposure and activities are perhaps aware if and when exposed – for example, in EWCs – to occasional references to sustainability reporting by their employers. But things are very different with regard to the interest and knowledge of the vast majority of trade union activists and officials. A Bulgarian report with findings of first surveys related to non-financial reporting since 2007 shows that most companies (even those that have accepted the National Code for Corporate Governance) prefer not to disclose most of the relevant information, especially information concerning environmental issues, health and safety at work, business strategy and marketing. As in Greece, reporting in Bulgaria is occasionally to be found in companies with EWCs, with trade unions only being marginally involved. The trade union confederation CITUB has criticised the fact that relations between corporate governance and the existing mechanisms for workers’ information, consultation and participation have not been clarified.9

Nowadays rigid austerity policies exert a strong influence on the ‘climate’ for fruitful talks. Trade unions often consider it a luxury to discuss sustainability issues when established social dialogue on traditional core items is under threat. Changing legislation reduces workers’ opportunities to get involved in companies’ reports, and trade union involvement is minimised by deregulation, which can easily lead to the

destruction of social dialogue, not its enhancement. In Romania this has led to a rupture, not a strengthening of internal and external reporting. The trade unions in Latvia take part in the public debate and discussion of sustainability issues to some extent; but they do not seem to be playing a leading role. Besides rather outdated information provided on websites and sympathy for the ‘greening’ of the economy, the Portuguese trade unions do not really have a prominent role in debates on sustainability and non-financial reporting and other worries prevail. The key concern of the trade unions in Ireland is the preservation of jobs and dealing with the fall-out from the deep economic recession the country is experiencing, as well as the austerity measures introduced by the IMF, ECB and European Commission (the so-called ‘troika’). The trade unions in Malta have been engaged in public debates about sustainable development and energy policy. Non-financial reporting, characterised by voluntarism rather than by legal provisions, has only been touched upon in the field of health and safety. Although the trade unions in Slovenia are involved in debates and initiatives promoting sustainable development of companies it can be concluded that they are currently fairly inactive in this area. In Spain, a political initiative on worker’s participation in corporate social responsibility was launched in 2010 by a group of Ministry for Employment and Immigration experts. However, this was not included in the final legislation. Although non-financial reporting and CSR are not prominent issues in industrial relations debates, the major Spanish union confederations (CCOO and UGT) have included the issue of corporate social responsibility in their agendas.10

The trade unions in Sweden are as interested as any other group in society in participating in creating sustainable companies, whether in terms of the environment, the economy or social responsibility. Danish companies listed on the stock exchange have to comply with the reporting obligations enforced by the stock exchange. In companies where the employees have elected representatives to the company board, they are involved in producing the report. The trade unions in the Czech Republic support the trend towards sustainability-oriented issues and share the view that companies should strengthen their efforts towards sustainability. The unions have been calling for the establishment of a general and compulsory framework of corporate social responsibility, but their overall involvement is fairly weak. The manual ‘Corporate Social Responsibility’

that was created in the Czech Republic provides basic information about corporate social responsibility and the role of the social partners and also refers to sustainability and non-financial reporting. In order to promote integration and reduce competition, Italian trade unions, in line with the European social partners, have pressed for a negotiated road to CSR through adopting the most inclusive and participatory approach in defining CSR instruments. One example of the trade unions’ attempt to maintain CSR instruments within a balanced control framework based on a participatory approach is the increasing inclusion of so-called ‘corporate welfare’ in collective bargaining at national and company level. These are collective services from which workers benefit not only as employees but also as citizens, such as health insurance, pension plans and healthcare systems. It is striking that in some Italian cases, such as Unicredit, a clear distinction exists between primary stakeholders (employees, clients, shareholders and supervisory authority) and secondary stakeholders (media and opinion leaders, NGOs, trade unions, EWCs and consumer associations), while in other cases, employee representatives and trade unions are not even mentioned in the sustainability report.

British trade unions are involved in the environmental debate and several have developed environmental policies for their industries. The TUC is conducting a survey of union activists to examine their activities concerning environmental and climate changes issues (TUC 2009). In Norway, a distinction can be made between the national level (trade unions involved in several sustainability codes) and the local level (the more ‘dirty’ the industry, the more environmental concerns are seen as issues for collaboration with the unions). The Belgian unions have claimed their place in the debate on sustainability, starting from the point of view that Corporate Social Responsibility begins where legislation stops (ABVV 2007). Nevertheless, a round table with trade union representatives on this issue in Belgium in the early 2000s concluded that trade union organisations and workers’ representatives still had little to contribute to a social audit process. The Belgian trade confederations have taken the initiative in the Flemish part of the country to create, with environmental NGOs, an organisation called Arbeid & Milieu (Labour & Environment). One of the key goals is the conclusion of covenants setting

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12. In Norway research is ongoing on sustainable companies. See: http://www.jus.uio.no/ifp/english/research/projects/sustainable-companies
stricter targets for major companies and sectors. In the chemicals sector, a responsible care project has been initiated with trade unions as partners. It involves a commitment to continuously improve health, safety and environmental performance.

The Polish trade union Solidarność was involved in a project initiated by the employers’ organisation Lewiatan with the participation of Deloitte and funded by the EU on the Promotion of CSR standards in the enterprises. One of the outcomes of this project was the setting up of a website; another outcome is the report ‘Mistakes and obstacles in the dialogue with stakeholders in Poland’. The report identifies the main weakness of CSR in the country as the failure to engage in dialogue with workers. Improving cooperation with works councils and trade unions is recommended as a remedy (Gólcz et al. 2011). The Norwegian Trade Union Confederation has revised its Strategic Climate Plan, which emphasises the need to incorporate sustainability efforts into traditional forms of cooperation. In collective bargaining in Norway several agreements have been concluded which include references to employee responsibility and sustainable development as well as statements on employers’ obligations to engage in consultation and trade union representatives’ right to demand it. In practice, a large number of environmental and climate change issues could be covered. Social partners in the Netherlands have – both separately and jointly – produced statements on sustainability and CSR, and in 2012, eight transnational companies of Dutch origin established the Dutch Sustainable Growth Coalition. It is important to mention that the Dutch unions prefer integrated reporting to separate reports.

By means of collective bargaining, trade unions and a few companies have started to go beyond what is laid down in the law and have signed transnational agreements on fundamental labour rights and CSR at the international or European level. French unions in particular are fully engaged in negotiating and signing international company agreements, which are seen as a vehicle for promoting and securing employee and human rights worldwide and for putting pressure on companies for more transparency. International framework agreements have been signed by global union federations, and sometimes also by EWCs and/or national unions, which introduce reporting or monitoring procedures with a role for employee representatives. The latter can be either the global unions themselves, the EWC or a special body. Danone was the first company to sign an agreement in 1988 and in the meantime has signed several others
that include a special reporting procedure monitored bilaterally by the company and the global union federation IUF. EDF has an agreement on social responsibility that contains environmental standards, which was signed in 2005 by four global union federations as well as by national union federations present in the company and its foreign subsidiaries.

In Austria, the trade unions and the Chamber of Labour have been trying for a long time to clarify the provisions on non-financial performance indicators in company law (Unternehmensgesetzbuch). Particularly interesting in this respect is a report commissioned by the Danish LO that explicitly brought together a series of social, human rights, environmental and work environment standards that can be used in reporting (Oxford Research 2003). Although not unified in this respect the French unions are very active. Union leaders from the CFDT took the initiative in 2002 to create Vigeo, the second social rating agency in France (Vigeo 2010). The CFDT has made use of a stakeholder approach to stress the links between the taking of a sustainable long-term approach by companies, corporate governance, CSR and employee participation. Trade unions in Germany have been at the forefront of developing national sustainability codes, demanding the closer involvement of workers’ representatives in implementation policies at company level, which can serve as crucial ‘messengers’ of sustainable practices. Workers’ representatives can function as efficient controllers of compliance with companies’ commitments. Non-financial information has to be given in a separate sustainability report. The DGB has suggested examining the basic principles of the German national CSR forum, for instance, fair treatment, efficient and respectful use of resources, social and ecological chain production, human rights and global standards, cultural diversity and transparency.13 The Swiss unions have organised campaigns through the union-related NGO Solidar Suisse to promote workers’ and human rights in public procurement. The Swiss unions also participated in the work of the national standardisation institutions that dealt with sustainable company practices, such as the norm (Social Accountability) SA8000 and ISO Norm 24000, and in related compliance supervision.

6. Beyond the minimum – some practices

If the ‘laissez faire’ attitudes and low-key policies adopted by some companies and to a certain extent even signalled among the social partners and governments are left aside, a few interesting practices on how the workforce can influence sustainability practices can be mentioned.

Firstly, reference can be made to company portals/websites with information on CSR reporting or on annual reports about the implementation of a corporate governance policy. In general, listed companies must make public any information that could affect the share price and thus this information becomes available to shareholders and other stakeholders. In some countries there are ‘competitions’ or comparable incentives in this area. In Slovenia for example the business daily Finance and Business Academy awards prizes (according to various criteria) for the best annual company reports. In 2011, the competition was held for the twelfth time. Prizes were given in several categories, including for the best sustainability reporting in the annual report.

Besides this, specialised bureaus such as Alpha in France have pursued analytical research. In its analysis of the practice of the 40 most important listed companies, Alpha deplores that works councils rarely exercise their legal options (Alpha Group 2012). If there are employee representatives on the management or supervisory board, they too are rarely involved in companies’ social and environmental reporting. Furthermore, the quality of reporting is still insufficient: it tends to be merely a communication exercise (Seguin and Fayolle 2010). In Poland, Accreo Taxand and GES Investment Services have prepared an analysis at the request of the government on the state of non-financial reporting of state enterprises and companies owned or co-owned by the state.14 In Germany, an interesting study was published in 2010 on CSR and codetermination with five case studies: Norsk Hydro, Danone GmbH, Beiersdorf AG, Unilever and Wilkhahn (Beile et al. 2010). Another German study in 2010 on personnel reporting, after evaluating the reports of the DAX 30 companies showed a trend towards wider and more extensive reporting practice in human resources; most companies included the information in their sustainability reports (Wilke and Beile 2010).

Akzo Nobel, DSM, FrieslandCampina, Heineken, KLM, Philips, Shell and Unilever and supported by the employers’ confederation VNO-NCW. The basic philosophy is expressed as follows: ‘shape’ (development of sustainable strategies that lead to added value), ‘share’ (exchange of good practices) and ‘stimulate’ (development of policy recommendations) (EY 2012). However, in the list of stakeholders (international and Dutch communities, governments, consumers, investors and civil society, including NGOs and universities) there is no explicit reference to workers’ representatives. In a study by the Austrian Chamber of Labour the annual reports of large Austrian companies were evaluated in terms of employee-related indicators. The study was based on a sample of 108 companies, chosen from the 500 largest in the country (Goldberg 2009).

In previous sections, reference has been made to the modest role of European Works Councils. In some countries, the EWC is the only way to get information. In such cases, EWCs have an important monitoring role in verifying the correct application of CSR policies. In Italy several examples could be found. In the case of Unicredit, for example, EWC members were asked to take part in selecting what themes should be dealt with in the sustainability report. The practice at ENEL seems to represent an exception as the Protocol signed in 2009, along with the CSR Protocol, provides for the setting up of a Joint Committee made up of company representatives and union representatives: a special forum in which the company and the unions can address the industrial, environmental and employment strategies that ENEL intends to pursue.

7. Summary

Transparency in reporting and open communication can be important elements of a company’s social policy and are considered a key part of the Sustainable Company. These activities can contribute to a positive image and demonstrate that social responsibility is taken seriously, not just lip service to international standards or abstract codes. Non-financial reporting on sustainability-related issues to the company’s own workforce indicates that shareholder value is not the company’s sole concern and that a committed workforce is a key objective.

The normative framework for non-financial reporting sketched out here takes a number of different forms. The regulatory framework for industrial relations and the labour market traditions in European countries are
also different in this regard. In a very general way we can distinguish four types of norms related to non-financial reporting:

(i) Norms derived from legislation, with either a mandatory or a non-binding character.

(ii) Norms based on corporate governance and/or corporate social responsibility codes and principles, almost always of a voluntary nature.

(iii) Norms formulated in collective agreements, with compliance control a task for the contracting partners, greatly depending on the discipline and strength of the partnership.

(iv) Norms settled in individual companies through company agreements, international framework agreements, codes of conduct and the like, with different signatories (workers’ representatives, works councils, trade unions, European or global unions) or unilaterally.

The dominant reporting registered is of a non-binding character, although regulation has proven to be an effective mechanism for enforcing change in internal reporting systems and improving public reporting practices (Eccles et al. 2010). The ‘comply or explain principle’ often referred to in the field of corporate governance in relation to minimum auditing standards for companies has not found its way into non-financial reporting. The overall picture that emerges is the prevalence of voluntary norms: with few exceptions the normative framework in European countries is a mixture of non-binding legislation and CSR codes based on voluntary compliance. In summary:

(i) With some exceptions, sustainability reporting continues to be a management prerogative and the output of a unilateral top-down process. The participation of workers’ representatives at the highest level of decision-making (as in Germany) is one of the only guarantees of a more equal footing in reporting issues. But even codetermination as such is not a warranty.

(ii) In several countries a tradition of dialogue has been established, mainly in the form of national-level (or sometimes, sectoral level) dialogue at round tables, meetings of national Economic and
Social Councils and of other national social dialogue bodies related to CSR policy.

(iii) Issues of non-financial reporting and sustainability are being approached in connection with corporate social responsibility policies, often with reference to the EU’s promotion of CSR.

(iv) For listed companies, discussions about ‘new economic regulations’, which contain certain obligations with regard to social and environmental reporting, have become more topical in recent years.

(v) Hardly any bridge can be found between ‘ordinary’ workplace-related issues and sustainability goals.

(vi) The overall picture is not uniform: in some countries, integrity issues are at the forefront of companies’ concerns, while in others company image and ‘social behaviour’ or elements of HRM policy with a direct effect on family life are among non-financial concerns.

It can be concluded that, in the majority of European countries, not enough ground has been gained. There is a substantial group of countries that have made no progress. In other countries there is no evidence that non-financial reporting practices of individual companies go beyond traditional items; in any case, workforce and workplace conditions are not seen as a key part of sustainability concerns and workers’ representatives and their organisations are too often absent. Non-financial reporting in which environmental, social and economic indicators are combined with a view to illustrating the work environment and the influence on the surrounding society is still in its infancy.

In the section dedicated to disparities between internal and external reporting the findings were rather patchy. Given the limited amount of specific internal reporting on sustainability issues to workers and their representatives it is difficult to discern a link between internal and external reporting. Second, even in countries with developed CSR and corporate governance practices overall, compliance with reporting is still not marked, at least from a European angle (although significant differences exist). Third, the reporting that does take place is addressed mainly to the market and to shareholders. Although case study evidence shows that workers’ representatives expect more and/or earlier
information than what is provided to the shareholders and the general public, it is a common complaint that they receive only information that has already been made public (internally or to shareholders). This ranges from countries with no significant reporting, to countries with reporting that is mainly restricted to financial and economic issues and finally to countries with a substantial part of reporting dedicated to social policy and CSR items. In countries often labelled ‘leaders of the CSR pack’ efforts to integrate notions of CSR with sustainability can be documented. However, adequate research on the magnitude of compliance and real impact on company behaviour is often lacking.

Trade union involvement reflects the current state of play with regard to the incidence and quality of non-financial reporting. The presented range of reporting practices manifests itself in a similar range with regard to the trade union role: from completely absent to a serious partner in bargaining and in defining performance indicators. The current rigid austerity policies being applied throughout the EU strongly influence the climate for talks and even established social dialogue about traditional core items is under threat. Deregulation is reducing workers’ opportunities to be involved in company reporting and trade union involvement is being minimised. Trade unions in many countries often regard discussion of sustainability issues as a luxury these days.

In a second category of countries trade unions take the view that they are in a similar situation to any other stakeholder, with no specific demands beyond aiming at a general and compulsory framework for corporate social responsibility. This framework might be the result of a negotiated process or reporting obligations enforced by a stock exchange.

A third category of countries has a tradition of branch-related involvement, with unions that have tried to clarify the provisions on non-financial performance indicators in dialogue and union activists examining environmental and climate change activities. Among key goals is the conclusion of agreements setting stricter targets for major companies, sectors or projects with the aim of improving work and environmental performance. Results vary from recommendations to improve cooperation with works councils and trade unions to agreements with references to employee responsibility and sustainable development. International framework agreements on fundamental labour rights and CSR can be seen as a transnational version of these activities.
Finally, there are countries in which the unions have been trying to clarify the provisions on non-financial performance indicators in national company law. This can lead to participation in national standardisation or rating institutions or to union campaigns in favour of the development of national sustainability codes.

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Chapter 7
Can International Investment Agreements support labour standards?

Ulrich Mückenberger

1. Introduction: international investment as a challenge

The Sustainable Company respects and promotes a threefold dimension of sustainability: economic, ecological and social. With a view to satisfying these three dimensions investment plays a particularly significant role. Investment is a crucial factor for the achievement of the three sustainability factors because it precedes and determines the operational functioning and the outcomes of production in enterprises. Whoever controls investment also he to a large extent controls conditions and impact of work. Whoever wishes to support the Sustainable Company hence should focus on investment as a potential source of (or obstacle to) sustainability.

Whereas the economic efficiency dimension will normally be addressed by companies themselves, the social and the environmental dimensions often require other – often firm-external - actors to be seriously and non-opportunistically achieved. ‘Stakeholders’ - those affected by the firms’ working conditions and/or environmental impacts – have to address the firm with their respective ‘stakes’ via communication, and frequently even public pressure, in order to have these dimensions respected. This is why these stakeholders will also strive to have an impact on investment.

These considerations hold not only for the national level, but even more for the transnational and global level. Within the national setting social and ecological dimensions are often pursued and guaranteed by states. Multinational companies (MNCs), however, often operate transnationally in a ‘state-free’ zone. This makes it even more important to agglomerate non-state stakeholders to raise their voice and to try hard to impact company behaviour – not only to improve conditions in the less developed parts of the world, but also, indirectly, to protect the integrity of conditions in their western home countries (Gerlach et al. 2011).
For decades, international investment policy has been dominated, even monopolised, by MNCs and states. In recent years, however, several new trends have come to the fore. Due to rising public awareness and changing business ethics, more and more globally acting MNCs at least claim to follow Corporate Social Responsibility (CSR) rules, including in their investment strategies. More and more rule-setting documents confirm MNCs’ social and environmental obligations when investing or operating in a host country (sections 5 and 6). And what is astonishingly little-known by the broad public: Since the Lisbon Treaty took effect in 2009, both foreign direct investment (FDI) and investment agreements fall under the competence of European Commission, Council and Parliament (Art. 206 and 207 FTEU), thus enabling a common European investment policy (section 7). Strangely enough: This new EU competence has been made visible, in a negative sense only, by the opaque EU - USA negotiations on TTIP (Transatlantic Trade and Investment Partnership) and their tendency towards liberalising and deregulating transatlantic markets. It could, however, equally be regarded as a tool, in a positive sense, of a welfare-oriented European foreign social policy. For the latter perspective, though not dealing with TTIP, I shall give some hints in section 7.

In this chapter I will draw attention to the hitherto neglected field of International Investment Agreements (IIAs) and show how they could become a component of a if hybrid (section 3) transnational regulatory system of work and ecology relations in firms’ investment policies. I will try to shed light on changes within this part of international law which allows for interactions with CSR rules, codes of conduct and hitherto not legally binding MNC guidelines.

2. Weakness of current international labour laws

Purely state-based ways for globalising labour law are in a deadlock. Since this is well-known and needs no deepening here, I will summarise my position developed elsewhere. It is true that there is nearly one century’s history of norm-building by the International Labour Organisation (ILO). This was, for the first time, a hybrid norm-building structure in the sense that representatives of employers and employees, together with state representatives, determine ILO Conventions and Recommendations. This creates an element of stakeholder voice, and hence of legitimacy, in ILO-norm-building. The weakness of ILO legislation is thus less a lack of
legitimacy, but rather lack of effectiveness (Hepple 2005). Though created in a hybrid way, ILO norms form part of traditional international law. This is why they have to be ratified by member states, as they enjoy legal validity only via ratification. Even if ratified, ILO norms are frequently far from being properly implemented and complied with. The reporting and experts’ assessment systems – in essence ‘naming and shaming’ – does not provide for real sanctions. The 1998 Declaration concerning four core labour standards – which is disputed under the aspect whether it can lead to universal standards even without member states’ ratification - cannot compensate for this lack of effectiveness. Core labour standards, even if legally universally binding, would have the same implementation problems as ‘normal’ Conventions and recommendations have.

This is why for some time now there has been a quest for other, more effective state or international organisations’ labour norms in the field of global trade and MNCs activities (Moreau 2006). But international organisations are either reluctant to articulate, recognise and support social and labour standards in their own field of activity (like the World Trade Organisation WTO), or they create ‘norms’ which are labelled as ‘guidelines’ rather than legally binding norms (like in the case of the OECD).

All attempts to internationally regulate labour and employment are, to a certain extent, important components of an emerging global social order. But on their own they are not enough to build a global legitimate and effective labour law. They need levers, actors and actor constellations which provide them with actual implementation power.

3. Transnational norm-building networks and global hybrid labour law

In the last couple of years I have done some work on how the architecture of a global labour regime which does not only rely on states and international organisations of states could look like.¹ What we observe is an emerging pluralism of legal phenomena concerning the worldwide activities of firms and their corresponding labour relations. Here we see a plurality not only among public norms, codes and guidelines, and among private codes of conducts, statements of intent and norm-building

¹. See Mückenberger (2010; 2011a; 2011b; 2011c) and Mückenberger and Jastram (2010).
agreements (Hepple 2005; see also Anner et al. 2013), but actually a plurality of ‘mixes’, of mutual interdependency and interaction between public and private ordering concerning labour relations. This is the source of what we can call global hybrid labour law.

The new component in this hybridity is the large amount of non-governmental ordering via firms and transnational norm-building networks. International-legal state regulation has a long history of regulation efforts and their ineffectiveness (see section 2 above). But it seems that in the last decades, long-term economic perspectives and civil society perspectives have been the main drivers of the emerging plurality of labour regimes. These provide both greater legitimacy of norms through bottom-up participation in norm-building and higher effectiveness of regulation through implementation and enforcement of rules near to the source of their origin. I called this mechanism ‘voice-entitlement-nexus’ (Mückenberger 2010). Due to the novelty of non-governmental norm-building in the transnational space I focussed, in my earlier work, on this side of hybrid labour law, i.e. on the non-governmental side.

However, it is equally possible – and in fact necessary - to start from the other side. The question, then, is: what type of intervention of states and international organisations is necessary in order to support and encourage, to ‘empower’ the labour regulating work of transnational norm-building networks (Jakobeit et al. 2010)? We know examples of state behaviour reinforcing global non-governmental regulation. Take as an example the ILO core labour standards, which were declared universally applicable in 1998. The effectiveness of this hybrid international norm requires reinforcement through state behaviour. The UN Global Compact for example (see Mückenberger and Jastram 2010), and the amended OECD Guidelines for MNCs (OECD 2011) both refer to the ILO core labour standards, as well as numerous procurement rules of states – this pattern of state behaviour gives higher authority, validity, and thus, effectiveness to the core standards, which otherwise would have remained ‘good-will declarations’.

A similar lever for non-governmental rules can lie in binding rules for FDI, since these rules do not only constitute obligations of host states vis-à-vis private investors. They can also contain obligations of investors

2. This is well documented in Moreau (2006).
vis-à-vis the host country and its citizens, as well as social and ecological rules for sustainability, which may include core labour standards and/or CSR obligations which would otherwise not be legally binding (for a general overview see Prislan/Zandvliet 2013). Let us look at International Investment Agreements (IIAs) as one such possible tool.

4. **Multilateral and Bilateral Agreements on Investment**

IIAs have a long and complex history, and their frequency has accelerated due to the rapid increase of FDI worldwide. They try to regulate those issues related to FDI like protection of property of investors, free trade and fair treatment of investors. Only recently have they started to contain obligations on investors as well – and this is the line we want to follow after a short historical review.

Investment agreements are only the logical consequence of free trade agreements (FTAs) in that they extend the framework of market principles to the earlier stage of investment. This is why many IIAs form part of international FTAs. For a long time this type of regulation used to be dealt with mainly through bilateralism – i.e. states concluded agreements bilaterally (between investors’ home and host countries), hence Bilateral Investment Treaties (BITs) or investment rules contained in bilateral FTAs (for legal detail see Bungenberg *et al.* 2014). BITs are frequently accompanied by Double Taxation Treaties (DTTs), which are not of interest here. The first BIT, between West Germany and Pakistan, was signed in 1959, and their numbers have grown steadily since then.

Due to the three facts 1) that FDI home states have relations with many potential or actual host states, 2) that home states, under the increasing FDI movement among OECD-countries, are frequently also host states and 3) that states want to ensure equal or comparable conditions for their investors, there have always been efforts to standardise and universalise IIAs. In the period of bilateralism, FDI home (and host) states began to develop ‘model BITs’ applied to the investment agreement negotiations with the bulk of host (or home) countries. We will encounter some of these model BITs later. Of particular interest will be the opportunity for an ‘EU model BIT’, which is an option since the coming into force of the Lisbon Treaty in 2009. It can provide an EU-wide frame for global investment, hence development and social policy. It is therefore of substantial interest for those who deal with sustainable investment.
Efforts to universalise investment conditions have failed so far. One of these efforts was the Multilateral Agreement on Investment (MAI), which was a draft agreement negotiated within an OECD-High level group in 1995-98. It encountered sharp opposition from civil society groups and developing countries, particularly because it threatened protective regulation in host countries. The host nation France announced in October 1998 that it was not supporting the agreement any longer.

The MAI draft (OECD 1998), in its preamble, renewed:

...their commitment to the Copenhagen Declaration of the World Summit on Social Development and the observance of internationally recognised core labour standards, i.e., freedom of association, the right to organise and bargain collectively, prohibition of forced labour, the elimination of exploitative forms of child labour, and non-discrimination in employment, and noting that the International Labour Organisation is the competent body to set and deal with core labour standards worldwide (OECD 1998: 9).

In the Annex NOT LOWERING MEASURES it stated:

A Contracting Party shall not waive or otherwise derogate from, or offer to waive or otherwise derogate from, its domestic health, safety, environmental, or labour measures, as an encouragement to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of an investment of an investor (OECD 1998: 9).

In the Annex of the OECD Guidelines for Multinational Enterprises (OECD 2011) the Declaration on International Investment and Multinational Enterprises (21 June 1976) is reaffirmed:

6. The Guidelines set out below are recommendations jointly addressed by Member countries to multinational enterprises operating in their territories. These Guidelines, which take into account the problems which can arise because of the international structure of these enterprises, lay down standards for the activities of these enterprises in the different Member countries. Observance

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3. ‘Interpretative Note: The Parties recognise that governments must have the flexibility to adjust their overall health, safety, environmental or labour standards over time for public policy reasons other than attracting foreign investment.’
of the Guidelines is voluntary and not legally enforceable. However, they should help to ensure that the operations of these enterprises are in harmony with national policies of the countries where they operate and to strengthen the basis of mutual confidence between enterprises and States (OECD 2011: 3).

The MAI hence did not contain any binding social or environmental standards. The chairman of the Negotiating Group, in his report concerning the annex, summarised:

Some delegations wish to consider the possibility of a more general provision on not lowering standards as well as additional ideas that would ensure that the MAI includes meaningful provisions on a range of issues related to labour and environment. It is still being considered whether the labour provisions should refer to domestic, or international core, labour standards. A few delegations oppose any provision on labour matters in the MAI (OECD 1998: 4).

One possible reason for the MAI’s failure was the absence of ‘meaningful provisions’ concerning labour and environment. From 1998 onward therefore, a new shift towards BITs took place. Numerous BITs had already been concluded before the MAI negotiations (Picciotto 1998). We shall observe their continued increase in section 5. In the new millennium, however, an additional tendency has come to the fore. International investment agreements experience ‘regionalisation’, i.e. it is no longer individual home and/or host countries that are negotiating terms of investment, but rather home and/or host world regions (like COMESA in southern Africa). The newly established EU competence in FDI regulation thus follows this trend. This regionalisation possibly provides a better starting point to reconcile both the wish to universalise terms of investment and the necessity to take into account diversity in the current world of FDI home and/or host countries.

5. **Empirical Data**

5.1 **Foreign Direct Investment trends**

Concern with investment regulation is driven by the fact that, within the globalising economy, globalisation of investment (FDI) has gained a dominant position since the 1980s. FDI flows, which had experienced a
decline during the financial markets crisis, have increased again in 2010 (UNCTAD 2011: Fig. I.1). In 2010, FDI amounted to 1.244 trillion dollars. It is true, however, that this is still 37% less than in the peak year 2008 and 15% less than the 2005-2007 average.

FDI inflows have undergone a substantial change during this period. Hitherto most of the FDI flew from developed to other developed countries. From the early 1980s onwards, FDI flows rose from nearly zero to over 1.4 trillion USD (2000) to a peak of nearly 2 trillion dollars (2006). Over the whole period most of the inflows went into the developed economies only a small share of FDI flows went into developing economies – e.g. over 1 trillion in 2006 (around 1.3 trillion). As against that, only ca. 20 per cent of a total of ca. 1.4 trillion dollars (2006) went to developing economies. In 2010, however, for the first time, FDI inflows of developing and transition countries surpassed those of developed countries (however with the level in transition countries remaining very low) (see Figure 1). This was the case, however, in a period of FDI inflows decline, due to the impacts of the financial markets crisis.

Figure 1  FDI inflows, global and by group of economies, 1980-2010 (billions of dollars)

Source: Based on UNCTAD (2011: 3, Figure I.3).
In contrast, FDI outflows of developing and transition countries stagnated over the last decade or so. Only South, East and South-East Asia showed a sharp and continuous increase till 2010 (UNCTAD 2011: Fig. I.7). FDI outflows from both developed and developing/transitional economies to developed economies, decreased, whereas these outflows to developing economies increased, at a higher rate from developed to developing countries, and at a lower rate but on a higher level from developing countries to developing countries (UNCTAD 2011: fig. I.8). Rising competition *between developing countries* thus expresses itself on the FDI field.

Figure 2  Distribution of FDI projects, by host region, 2007 and 2010  
(per cent)

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Source: Based on UNCTAD (2011: 8, Figure I.8).

A high proportion of FDI outflows takes place within global value chains of MNCs. What Gereffi *et al.* (2005) call ‘disintegration of production and integration of trade’ expresses an internationalisation not only of production but equally of investment. The production of components becomes internationalised via FDI and the components brought together via trade. Not only is there an increasing amount of FDI taking place, but also international investment is occurring in a way which creates mutual dependency and communication.
5.2 Bilateral Investment Treaty trends

We can observe a substantial increase of BITs and other IIAs particularly during the early 1990s. This may explain the efforts from 1995 on to negotiate the MAI. But we can equally observe that the rate of growth of BITs has decreased since shortly before the millennium. Although the cumulative number of BITs rises the annual number of new IIAs decreases. The rise obviously has to do with rising global FDI (for other factors see Guzman 2009).

The decline possibly also has to do with the fact that regional IIAs which do not fall under the category of BIT have gained ground (see UNCTAD 2012: 84ff.). There are aspects of investment discussed in the Trans-Pacific Partnership Agreement, with nine countries participating (Australia, Brunei Darussalam, Chile, Malaysia, New Zealand, Peru, Singapore, the United States and Viet Nam). Canada and Mexico were also formally invited to join negotiations and Japan has expressed an interest. In 2012 a trilateral investment agreement was concluded between China, Japan and the Republic of Korea. The EU Member States account for about half of the world’s BITs. New EU-wide investment treaties will replace BITs between the EU’s respective treaty partners and individual EU member States. For example, once concluded, the EU–India FTA is expected to replace 21 BITs signed by India with individual EU members. The Association of Southeast Asian Nations (ASEAN) has concluded agreements with Australia and New Zealand (2008) and China (2010) and is negotiating one with India. Last but not least, there is investment regulation within the Mexico–Central America FTA, which includes Costa Rica, El Salvador, Guatemala, Honduras, Mexico and Nicaragua.

Notwithstanding this trend towards regionalisation of IIAs it is still remarkable that there has been an increase from less than 500 to more than 3000 BITs within two decades. A particular ‘leap upwards’ took place in the years from 1989 (less than 50 annual IIAs) to 1995 (more than 200 annual IIAs). From then on the annual number of IIAs stagnated or declined. The cumulative number of IIAs, however, continuously increased. The bulk of the increase of IIA numbers was due to BITs - only a small, although increasing, percentage was ‘other IIAs’. This demonstrates the emergence of a novel instrument of economic and development policy (UNCTAD 2012: figure III.2.).
The World Investment Report 2012 quantifies this as follows (see Figure 3):

![Figure 3: Trends of BITs and ‘other IIAs’, 1980-2011](image)

Source: Based on UNCTAD (2011: 8, Figure I.8).

As I am interested in IIAs as instruments of developing and spreading global labour standards I turn now to the qualitative side of the BITs the contents of these agreements (Muchlinski 2009; Titi 2014) instead of the purely quantitative side (i.e. their numbers). In the last ten years or so, the trend towards investment liberalisation, though still prevailing, has been accompanied and partly even pushed back by trends towards regulation /limitation, in most of the national policies (UNCTAD 2011: ch. 3). Whereas regulation only concerned investors’ rights and protection of property under the auspices of liberalisation, in the context of limitation regulation concerns a new balance between investors’ rights and duties, such as in matters of the financial sector and of the control over natural resources. Even if many IIAs still are more of a technical nature, some of them deal with social and environmental issues. The 2011 World Investment Report, in its last chapter, fully focused on Corporate Social Responsibility (CSR). It is not by chance that here the ten UN-Global Compact Principles on Sustainability – among them the four ILO core labour standards – are proposed as possible contents of BITs (WIR

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4. It is an important background condition that among the ten countries with the highest number of BITs (June 2007: Germany 135, China 119, Switzerland 114, UK 103, Egypt 100, Italy 100, France 98, NL 91, Korea 86, Belgium and Luxembourg 84 – see Sauvant/Sachs (2009: xxxv)) all founder states of the EEC and a clear majority of western industrialised welfare states are present.
The 2012 World Investment Report (UNCTAD 2012) even proposes a broad range of sustainability goals to be inserted into investment agreements.

From the analyses of experts on this topic one can reconstruct three layers or generations of BITs according to their function and contents. The two first contained only investors’ rights, however, the third also includes investors’ duties.

The first layer can be traced back to post-colonialism in Third World countries. These countries needed finance and investment; however, the new revolutionary governments represented risks for investors and their home countries. In this layer BITs had the primary function of protecting invested property against expropriation, unrest and political obstacles.

The second layer was more economic than political. Investors and their home countries wanted open markets and free trade. This is why these BITs provided for conditions of trade and treatment of commodities and personnel adequate for a capitalist functioning of the firm and the market. This is why in these BITs same principles were embedded which also govern the World Trade Organisation: the national treatment principle (i.e. foreign investors have to be treated the same as domestic investors) and the most-favoured nation principle (i.e. if you provide favourable treatment to one nation, any other nation may claim this favourable treatment too). This layer of BITs extended former GATT (later WTO) rules to territories which were not (yet) member states.

The third layer, however, also dealt with obligations of investors and their home countries. Among these rules were a historical novelty: social and ecological standards. This layer, however, is all but systematically developed, and is often piece-meal. There is a broad range of differentiation (see the examples in table III. 3 of UNCTAD 2012; Muchlinski 2009):

- Certain BITs only provide social or ecological points of view in their preamble.

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5. This can be seen in a context with the 2011 Edition of the OECD Guidelines for Multinational Enterprises (OECD 2011) which contains the ‘Declaration on international investment and multinational enterprises’ of 25 May 2011. The latter tries to extend applicability of the sustainability rules of the Guidelines (ch. II. A and B) to the field of foreign investment.

— Others try to prohibit social or ecological dumping via host countries’ lowering their social or ecological standards for their own investors only, thus creating competitive disadvantage for foreign investors.

— Others try to protect the freedom of host countries to regulate in the public (political, social, ecological) interest (cf. the recent monograph of Titi 2014) and thereby interfere with the free market and free competition.

— Some are positively setting standards which have to be complied with by investors – in most cases confirming standards with a certain transnational authority (like the ILO core labour standards, or the UN Global Compact principles).

Behind this range of differentiation we certainly find different concepts of and motivations for regulation. Some of them are possibly inspired by the objective of ‘global social justice’. Most of them are far removed from this. Some preambles are pure ‘window-dressing’. Some purely pursue the aim to free and protect competition and the market from distortion. Some can also involve a sort of hidden or open protectionism (Mückenberger 2011c) in that they try to eliminate comparative – social or ecological – advantage of less developed countries and thus to exclude them from the market.\(^7\)

Nevertheless, if we strive to encourage universal social rights in the globalised world, we can reflect on whether this third layer of BITs (and regional IIAs) opens an arena of action with a perspective of sustainability. The UNCTAD, in its 2012 World Investment Report, favours an ‘Investment policy framework for sustainable development’ (UNCTAD 2012: 131 ff.) which builds on these new trends in BITs and other IIAs and their combination with new principles of sustainable investment (see below principles 5 and 10) and a fundamental change in national policies, in order to arrive at a ‘new generation of investment policies’.

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Footnote 7: The UNCTAD (2012) World Investment Report, on page 90, analyses 20 BITs concluded in 2011, which contain examples of sustainable-development-friendly aspects - such as stimulating responsible business practices, avoiding overexposure of host states to ISDS claims, preserving their right to regulate in the public interest and focussing on investments conducive to development.
Table 1  **Examples of sustainable-development friendly aspects of selected IIAs signed in 2011**

<table>
<thead>
<tr>
<th>Sustainable-development-friendly aspects of IIAs provisions (in order of frequency)</th>
<th>United Republic of Tanzania–Turkey BIT</th>
<th>Nigeria–Turkey BIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Detailed exceptions from the free-transfer-of-funds obligation, including balance-of-payments difficulties and/or enforcement of national laws</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Omission of the so-called &quot;umbrella&quot; clause</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Clarification of what does not constitute an indirect expropriation</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Fair and equitable treatment standard equated to the minimum standard of treatment of aliens under customary international law</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>References to protection of health and safety, labour rights, environmental or sustainable development in the treaty preamble</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Explicit recognition that parties should not relax health, safety or environmental standards to attract investment</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>A carve-out for prudential measures in the financial services sector</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General exceptions, e.g. for the protection of human, animal or plant life or health; or the conservation of exhaustible natural resources</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Exclusion of sovereign debt obligations from the range of assets protected by the treaty</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exclusion of portfolio investments (shares representing less than 10 per cent of a company’s capital) from the range of assets protected by the treaty</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>No provision for investor-State arbitration</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Can International Investment Agreements support labour standards?

<table>
<thead>
<tr>
<th>Policy objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focus on investments conducive to development</td>
</tr>
<tr>
<td>Avoid overexposure to ISDS claims</td>
</tr>
<tr>
<td>Preserve the right to regulate in the public interest</td>
</tr>
<tr>
<td>Stimulate responsible business practices</td>
</tr>
<tr>
<td>Source: Based on UNCTAD (2012: 90, Table III.3).</td>
</tr>
</tbody>
</table>
It is worth seriously testing whether or not, and if so under which conditions, such an effort for sustainable development which starts at the source of production and reproduction – i.e. at investment – has a chance. It could provide for a synthesis between development goals and the goal to maintain and improve labour and ecological standards in the industrialised world.

**Box 1  Key UNCTAD principles on sustainable development**

Principle 5: Balanced rights and obligations
Investment policies need to serve two potentially conflicting purposes. On the one hand, they have to create attractive conditions for foreign investors. To this end, investment policies include features of investment liberalization, protection, promotion and facilitation. On the other hand, the overall regulatory framework of the host country has to ensure that any negative social or environmental effects are minimized. More regulation may also be warranted to find appropriate responses to crises (e.g. financial crisis, food crisis, climate change). Against this background, this core principle suggests that the investment climate and policies of a country should be “balanced” as regards the overall treatment of foreign investors. Where and how to strike this balance is basically an issue for the domestic law of host countries and therefore requires adequate local capacities. International policies vis-à-vis foreign investors likewise play a role and – if not carefully designed – might tilt the balance in favour of those investors. The principle does not mean that each individual investment-related regulation of a host country would have to be balanced.

Principle 10: Corporate governance and responsibility
This principle recognizes that corporate governance and CSR standards are increasingly shaping investment policy at the national and international levels. This development is reflected in the proliferation of standards, including several intergovernmental organization standards of the United Nations, the ILO, the IFC and the OECD, providing guidance on fundamental CSR issues; dozens of multi-stakeholder initiatives; hundreds of industry association codes; and thousands of individual company codes (WIR11). Most recently, the UN Human Rights Council adopted a resolution endorsing the Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises. CSR standards are voluntary in nature and so exist as a unique dimension of “soft law”. The principle calls on governments to actively promote CSR standards and to monitor compliance with them. Promotion also includes the option to adopt existing CSR standards as part of regulatory initiatives, turning voluntary standards into mandatory requirements.


Certainly, when entering into the field of social and environmental standards, BITs tend to reproduce national labour law cultures internationally. I try to demonstrate that through one example of the American legal culture in order to compare it with a BIT that could better correspond to the European social model and the continental European law culture.

The United States (US) always reproduce the pattern of ‘social’ regulation set out in the NAFTA-Agreement which came into force in 1994 when it concludes international trade agreements. The side agreement on social standards (the North American Agreement on Labor Cooperation, or NAALC) establishes a legal regime which does not set social standards, let alone harmonise standards between the three contracting parties. It is rather an anti-social dumping measure insofar as it tries to set up a procedure against the situation where one of the NAFTA member state breaks its own social standards to achieve an unfair comparative market advantage vis-à-vis the other member states. This social regime is not a welfare-state system, but rather a competition law system focused on preventing the distortion of competition.

To give one illustrative example of such a BIT: the 2005 US – Uruguay-Agreement (SICE 2004). In its preamble, it contains social objectives:

Desiring to achieve these objectives in a manner consistent with the protection of health, safety, and the environment, and the promotion of consumer protection and internationally recognized labor rights (SICE 2004: 1).

The agreement, after establishing trade-oriented standards like the national treatment and the most-favoured nation principle, equally sets out an orientation towards ‘internationally recognised labor standards’ which seem similar to the ILO core labour standards (although the discrimination issue is missing):

Article 13: Investment and Labor
Para. 1 The Parties recognize that it is inappropriate to encourage investment by weakening or reducing the protections afforded in domestic labor laws. Accordingly, each Party shall strive to ensure
that it does not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such laws in a manner that weakens or reduces adherence to the internationally recognized labor rights referred to in paragraph 2 as an encouragement for the establishment, acquisition, expansion, or retention of an investment in its territory. If a Party considers that the other Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.

Para. 2 For purposes of this Article, ‘labor laws’ means each Party’s statutes or regulations, or provisions thereof, that are directly related to the following internationally recognized labor rights:

(a) the right of association;
(b) the right to organize and bargain collectively;
(c) a prohibition on the use of any form of forced or compulsory labor;
(d) labor protections for children and young people, including a minimum age for the employment of children and the prohibition and elimination of the worst forms of child labor; and
(e) acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health.

Para. 3 Nothing in this Treaty shall be construed to prevent a Party from adopting, maintaining, or enforcing any measure otherwise consistent with this Treaty that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to labor concerns (SICE 2004:17).

But when it comes to the enforcement procedures (Sections B and C) the agreement is totally silent about labour standards. Section B only allows ‘claimants’ (defined in art. 1 as ‘an investor’ of a BIT-party) to enforce their rights in the BIT. This excludes workers and their organisations, in other words investors’ duties are not enforceable. Section C regulates ‘State-State Dispute Settlement’. Art. 37 provides for access of ‘either Party to arbitration for a binding decision or award by a tribunal in accordance with applicable rules of international law’ (paragraph 1). The Agreement in para. 5, however, eliminates applicability of the dispute settlement procedure to labour (and environmental) standards (the latter contained in art. 12): ‘5. Paragraphs 1 through 4 shall not apply to a matter arising under Article 12 or Article 13.’ Here we do not even find an effective anti-social dumping procedure as provided for in NAALC.
It is true that the recent 2012 model BIT is more comprehensive in its substantive rules (particularly Art. 13). It also makes the anti-social dumping intention of the social clause clear from the very beginning. But when it comes to implementation and enforcement, in Sections B and C, the same restrictions mentioned above are repeated: no enforcement with a view to the obligations of investors, no state-state dispute settlement with regard to labour (and environmental) standards. With a view to global labour law, one could conclude to forget about BITs.

7. Europe can become a global FDI actor

It was mentioned earlier in this chapter that the role of Europe changed when the Lisbon Treaty entered into force on 1 December 2009 (see the legal analyses in Bungenberg 2013; Prislan and Zandvliet 2013; Arnauld 2014). Art. 206 and 207 of the Treaty on the Functioning of the European Union (TFEU) have extended the Common Commercial Policies so that they are now including ‘foreign direct investment’ (see Mestral 2011). The development may be understood as follows. After the failure of MAI during the later 1990s, international investment relations shifted to the field of BITs. At the same time there was an immense increase of FDI – not only between developed and developing countries, but also between developing countries themselves and between developing and emerging countries. As one of the effects of this, UNCTAD (2012b) observed the already discussed trend towards regionalisation of negotiation and conclusion of IIAs and the development of regional model agreements (UNCTAD 2012: section 5). In this context we can also interpret the amendment of art. 207 FTEU (ex-art. 133 TEC) in that it now provides for a European agenda on FDI and dealing with IIAs. There are hundreds of BITs between EU member states and third states and even 191 BITs between EU Member States (Mestral 2011). This makes it an important issue how the EU deals with existing BITs after 2009 and whether, and by whom and with which contents, it elaborates an EU model BIT.

Let us first give an overview of the new competences. Art. 207 TFEU reads as follows (see Box 2).
Para. 1 states that ‘uniform principles’ for common commercial policy are necessary with respect to FDI – as one objective protection of trade against ‘dumping’ is mentioned. Paras. 2 and 3 provide for an interplay between regulations (para. 2), by EP and Council, and agreements with one or more third countries or international organisations, by the Council.
(and the Commission) in accordance with art. 218 (para. 3). One guideline for the Council and the Commission is that ‘the agreements negotiated are compatible with internal Union policies and rules.’ Qualified majority for the conclusion of agreements is sufficient provided that, for the adoption of internal rules, a unanimous vote is not necessary (para. 4). Apart from regulations, the EP – except for the cases mentioned in art. 218 para. 6 TFEU – only has a consultative role (art. 218 para. 6 b and para. 10; art. 206 para. 4 sent. 5).

According to these provisions the EU seems capable of concluding agreements, including investment agreements, in accordance with the objectives mentioned in art. 151 TFEU\(^8\) and in the labour law provisions in art. 153 para. 1 TFEU. The EU thereby has to respect the requirement, if necessary, of unanimous vote in the Council according to art. 153 para. 2 TFEU.

The parties to the European legislative process seem to be well aware of the newly emerged opportunities for a common FDI policy. Their statements clearly focus on the issues combined with the two first layers of IIAs we identified earlier in this chapter (see section 5.b above): protection of invested property and of fair free-trade conditions. But all of them also hint at the third layer: social (and environmental) standards in global investment bargaining. There are, however, clear variations with regard to that general commitment. Two streams can be observed. One is to safeguard national autonomy in regulating issues that are of public interest (e.g. social standards). The other is to provide for an integrated FDI policy containing and encouraging social and environmental standards and their implementation vis-à-vis investors in the host countries. A third stream, and this currently seems to be the mainstream, is to avoid any decision between the first two – hence to wait and see ...

In its 2010 Communication (Reinisch 2013), the Commission stated that ‘Investment agreements should be consistent with the other policies of the Union and its Member States, including policies on the protection of

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\(^8\) ‘The Union and the Member States, having in mind fundamental social rights such as those set out in the European Social Charter signed at Turin on 18 October 1961 and in the 1989 Community Charter of the Fundamental Social Rights of Workers, shall have as their objectives the promotion of employment, improved living and working conditions, so as to make possible their harmonisation while the improvement is being maintained, proper social protection, dialogue between management and labour, the development of human resources with a view to lasting high employment and the combating of exclusion’ (art. 151 TFEU).
the environment, decent work, health and safety at work, consumer protection, cultural diversity, development policy and competition policy’ (European Commission 2010). It is in line with that that the Foreign Affairs Council, in its meeting concerning a comprehensive European international investment policy (Luxembourg, 25 October 2010) adopted the following conclusions:

The Council ... 16. RECOGNIZES the importance of the social and environmental dimension of foreign direct investment as well as the rights and the obligations of investors, and EMPHASIZES the valuable contribution of organizations like the OECD, UNCTAD and the ILO and their international instruments to the EU investment policy, especially in the field of corporate social responsibility. At the same time, it remains crucial that the main focus of international investment agreements should continue to be effective and ambitious investment protection and market access; ... (Council of the European Union 2010:3).

Interesting is both a vague reference to CSR and a clear commitment to the two first (i.e. the market-liberal) layers of IIAs.

As against that, the European Parliament, in April 2011, in its resolution on ‘European Investment Policy’ (nr. 25) very clearly maintained that the two types of EU policy should now be adopted: protection of the right to regulate and inclusion of social and environmental standards.

*Protecting the right to regulate*

23. Stresses that future investment agreements concluded by the EU must respect the capacity for public intervention;
24. Expresses its deep concern regarding the level of discretion of international arbitrators to make a broad interpretation of investor protection clauses, thereby leading to the ruling out of legitimate public regulations; calls on the Commission to produce clear definitions of investor protection standards in order to avoid such problems in the new investment agreements;
25. Calls on the Commission to include in all future agreements specific clauses laying down the right of parties to the agreement to regulate, inter alia, in the areas of protection of national security, the environment, public health, workers' and consumers' rights, industrial policy and cultural diversity;
26. Underlines that the Commission shall decide on a case-by-case basis on sectors not to be covered by future agreements, for example sensitive sectors such as culture, education, public health and those sectors which are strategically important for national defence, and asks the Commission to inform the European Parliament about the mandate it received in each case; notes that the EU should also be aware of the concerns of its developing partners and should not call for more liberalisation if the latter deem it necessary for their development to protect certain sectors, particularly public services;

_Inclusion of social and environmental standards_

27. Stresses that the EU’s future policy must also promote investment which is sustainable, respects the environment (particularly in the area of extractive industries) and encourages good quality working conditions in the enterprises targeted by the investment; asks the Commission to include, in all future agreements, a reference to the updated OECD Guidelines for Multinational Enterprises;

28. Reiterates, with regard to the investment chapters in wider FTAs, its call for a corporate social responsibility clause and effective social and environmental clauses to be included in every FTA the EU signs;

29. Requests that the Commission assess how such clauses have been included in Member State BITs and how they could be included in future stand-alone investment agreements as well;

30. Welcomes the fact that a number of BITs currently have a clause which prevents the watering-down of social and environmental legislation in order to attract investment and calls on the Commission to consider the inclusion of such a clause in its future agreements (European Parliament 2011:7).

These two dimensions of EU FDI-policies - protection of right to regulate and inclusion of social and environmental standards - would be important both externally and internally. Both would recognise the obligation of the EU to behave not only as a market societal, but rather as a social-state or a federation of social states. From an external (i.e. EU

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9. I have given legal scholarly evidence for the claim that the EU is committed to comply with principles of social statehood derived from the constitutional values of human dignity, democracy and solidarity in European primary law cf. Mückenberger 2014.
external policy) perspective they provide for two functions. Host
countries of FDI are thus protected against a potentially endless
competition constraint to lower their social and ecological standards in
order to attract FDI. And investors would be subjects, not only of rights,
but equally of duties (e.g. the ILO core and other labour standards) which
they owe to host countries and their working populations.

But the internal (i.e. EU social policy) perspective of such EU-foreign
social policy should not be forgotten. The dimension of protection of right
to regulate would be directed directly against the recent European Court
of Justice invectives against national social policies challenging national
autonomy under an alleged hegemony of freedom of competition – as
known from the Viking/Laval-jurisprudence, particularly the Luxembourg
case.10 As against that, the inclusion of social and environmental standards
in EU BITs would emphasise the European social model enshrined in art.
151 TFEU which prescribes for EU and their member states ‘as their
objectives the promotion of employment, improved living and working
conditions, so as to make possible their harmonisation while the
improvement is being maintained, proper social protection, dialogue
between management and labour, the development of human resources
with a view to lasting high employment and the combating of exclusion.’
Such an emphasis could be understood as a recognition of European
social-statehood (Mückenberger 2014) and as a cosmopolitan EU
approach and would possibly ease the way to an agreement on Union
accession to the European Convention for the Protection of Human Rights
and Fundamental Freedoms, as allowed in Art. 215 FTEU (see Lörcher
2013).

Disappointing is the ‘follow up’ of the European Commission from 5 July
2011 to the cited EP resolution:

With regards to the inclusion of social and environmental standards
in future EU agreements, there is a strong convergence between the
views expressed by the European Parliament in the Resolution and
the Commission’s own ideas expressed in the Communication
towards a comprehensive European international investment
policy, as well as with existing practices in Free Trade Agreements
either concluded or currently under negotiation. Member States'

Rüffert 2008; Luxembourg 2008.
practices and concrete ways to introduce such clauses in future stand-alone investment agreements will be further assessed on an informal and continuous basis, with a view of identifying and implementing the best relevant practices (European Commission 2011: 1).

The Commission stresses ‘a strong convergence’, then, however, instead of taking up the convergence practically, pleads for a ‘further assessment on an informal and continuous basis’ and for a look for ‘best practices’. This reaffirms the before-mentioned third stream, the mainstream, of ‘wait and see’.

So, on a European level, there is something like an open situation. There is a non-decision between a liberal-market-oriented and a sustainability-committed international investment agreement policy. The recent debates on TTIP, however, seem to hamper this open situation in a manner that the EU only broadens markets, not social and societal perspectives. The debates, mainly secret and without democratic transparency, concentrate on free trade, non-state dispute settlement etc. (see the superficial overview in European Commission 2014). They fail to identify and operationalise a world-wide social model which seriously takes into account the triangle of sustainability: economic, social and ecological progress.

8. Conclusion: trade unions as mid-wives of a new European FDI policy?

There seems to be a window of opportunity for trade union activism in the field of foreign common commercial investment policy - beyond TTIP and market-liberal only concepts. This specifically holds for the elaboration of guidelines for EU Member state-internal and -external BITs, possibly even for a European model-BIT (for a sceptical view see Mestral 2013). The FDI issue and its regulation are on the agenda worldwide. It has been pushed, through the Lisbon Treaty, on the EU agenda too. All legislative actors are, albeit differing considerably with regard to precision, in favour of adding sustainability aspects into the existing and future BITs. There is a lack of consensus, however, though not open, on whether these sustainability aspect should be limited to the conservation of national regulation autonomy or whether they could encompass harmonising global social and environmental regulation.
Here the European and global trade unions can enter into the game. They can provide active support to the side which wants to harmonise social standards, not only on a European level, but which moreover, in a cosmopolitan way, wants to pave the way for a global floor for social rights. This is a chance for the efforts to give momentum, not only to the European Charter for Fundamental Right, but equally to wider social standards like the European Convention for the Protection of Human Rights and Fundamental Freedoms and the ILO labour standards.

In doing so, however, trade unions should keep in mind the risk of hidden protectionism connected with the claim of universal social and environmental rights (Mückenberger 2011c). A trade union cosmopolitan strategy with respect to international investment agreements has to provide and encourage a two-step agenda: first supporting and strengthening universal labour rights; second caring for efforts to make less developed countries capable of complying with and implementing these standards.

This two-step agenda was already proposed in 2001 in the ‘Manifesto Social Europe’ edited by the European Trade Union Institute (Mückenberger 2001). Section 8 of the Manifesto – under the heading ‘Global Economy – Global Solidarity’ – reads as follows:

The 1999 WTO Conference in Seattle demonstrated that Social Europe must include a global dimension. Not only the common agricultural policy, but also social policy in Europe can impact on less developed parts of the globe. Social rights are universal rights, but their achievement in the poorest countries of the world imposes an obligation of solidarity on the EU. If the EU expects poor countries to honour universal standards, it must undertake to shoulder the cost which they can less easily afford. Anything else is mere cynicism.

Social Europe needs to shape and implement instruments and measures to enable poorer countries to adopt and implement social standards (Mückenberger 2001).

In conclusion, at present, there seems to be the ‘kairos’ (the window of opportunity) to take first steps in the direction of norm-building for sustainable foreign investment – in an important and up-to-date part of EU foreign policy: FDI and investment treaties.
Can International Investment Agreements support labour standards?

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Chapter 8
The ETUC on the way towards sustainable European employee involvement

Wolfgang Kowalsky

1. Introduction: the challenge

The concept of a Sustainable Company is based on several cornerstones (Vitols 2011) which need to be put together like the pieces of a jigsaw puzzle. One of these cornerstones is worker involvement, since it enables and is necessary for the exercise of ‘worker voice’ in corporate governance and company affairs. The focus of this chapter is the need to Europeanise and modernise workers involvement and to have a close look at the evolution of the ETUC in embracing the Sustainable Company concept. Recent progress towards a unanimous position on board-level representation¹ (ETUC 2014a) constituted a historical breakthrough and clarified the position on an important cornerstone of the Sustainable Company concept. This chapter spells out the elements of this picture more clearly and details this significant step in the direction of supporting the Sustainable Company.

The EU’s corporate governance framework combined with short-termism was one of the root causes of the financial crisis which commenced in 2007. It demonstrated the failure of the old corporate governance model, thus strengthening the assumption that the European Commission would draw some lessons from it.² A shift away from the current shareholder-centric approach is needed to move towards a stakeholder approach based on stronger stakeholder rights, in particular strengthened workers’ involvement prioritising the long-term interests of the company.

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¹ Participation means the influence of employees’ representatives by way of the right to elect or appoint members of the company’s supervisory or administrative organ and the right to recommend and/or oppose the appointment of some or all of the members of the company’s supervisory or administrative organ (analogous to the SE, article 2).
² The Commission proposal on the Shareholder Rights Directive (COM/2014/0213) is based on the approach to empower shareholders, but there is no evidence that shareholder empowerment creates pressure for a longer-term perspective. As underlined by Frank Bold, the proposed Directive might be used to push managers towards even more short-term decision making.
However, the financial, economic and social crisis has not yet been adequately addressed to promote sustainable growth through sustainable companies.

In a company, a balanced and fair decision-making process should reflect a plurality of interests including all major stakeholders. Amongst the stakeholders, employees occupy a special position. In many Member States, company law traditionally recognises the plurality of stakeholder concerns and the notion of the ‘interests of the company’ as a guiding principle. A separate chapter on the role of stakeholders in corporate governance was inserted into the OECD Principles of corporate governance in 2004.

By creating a building block for workers’ information, consultation and board-level participation the EU should contribute to a concept of corporate governance that is in line with the European social model and that clearly distances itself from the primacy of shareholders’ interest in the debate about good corporate governance.

Shareholder value orientation has not improved corporate governance in many companies, quite to the contrary. A massive increase in inequality (Eurofound 2015) was a consequence of the old corporate governance model, and one of the main contributors to this trend was the huge increase in the remuneration received by the top management of the largest companies. One relevant factor which would restrain the upward spiral of remuneration would be the inclusion of workers’ representatives on company boards.

Jean-Claude Juncker and Martin Schulz, as candidates for the Commission presidency in 2014, took a stance in favour of setting a European minimum standard on employees’ board-level representation, but unfortunately never did come back to this campaign pledge (Mitbestimmung 5/2014). The ETUC declared that it was ready to contribute actively to this work while making clear that this is not about introducing any form of co-management or collaboration but of strengthening workers’ influence, in particular possibilities for the control and supervision of important company decisions affecting the workforce. From an ETUC perspective, employee board-level representation is not about extending German co-determination or any other national model; it is different as it would be genuinely European, covering European company forms in a first step and transnational companies in a second step. The
logic is to strengthen and broaden the right to workers’ representation in order to broaden workers’ strategic influence in company decision making.

The ETUC recommends that the Commission draws lessons from the corporate governance crisis and proposes a new framework for more democracy at work – or at least: to review the operation of existing Directives on employee involvement with a view to proposing suitable amendments where necessary. The triple objective should be to promote sustainable companies, good corporate governance and stakeholder participation and ‘catch-up Europeanisation’ of workers’ involvement.

2. **A fragmented and incomplete European architecture of corporate governance – the role of workers’ involvement**

European company law looks like an arbitrary patchwork, like an incomplete mosaic. Information and consultation are individual fundamental rights permitting no thresholds, and at the same time there are collective rights for European works councils, works councils and worker representation in general. Pursuant to Article 151 of the Treaty, a particular objective of the Community and the Member States is to promote social dialogue between management and labour. Point 17 of the Community Charter of Fundamental Social Rights of Workers provides that ‘information, consultation and participation for workers must be developed along appropriate lines, taking account of the practices in force in the various Member States’. Point 18 stipulates:

Such information, consultation and participation must be implemented in due time, particularly in the following cases:

— when technological changes which, from the point of view of working conditions and work organisation, have major implications for the work force are introduced into undertakings;
— in connection with restructuring operations in undertakings or in cases of mergers having an impact on the employment of workers;
— in cases of collective redundancy procedures;
— when trans-frontier workers in particular are affected by employment policies pursued by the undertaking where they are employed.
The Community framework on employee involvement intends to support and complement the action taken by Member States in the field of information, consultation and participation of employees.

The information and consultation directives\(^3\) – which have been the subject of a social partner consultation since April 10, 2015 – establish a minimum standard for workers in Europe, in particular in view of collective redundancies and transfer of undertakings. These directives urgently need updating as company restructuring has become a permanent feature of company life. Restructuring and anticipation of change are not yet dealt with in these directives. First and foremost, provisions on anticipatory management of change need to be taken up, but also stronger consultation rights with a view to reaching an agreement via meaningful social dialogue before any decision can be finalised. Stronger sanctions are necessary to end the situation of workers being put devant le fait accompli. The information and consultation must include the value chain, upstream suppliers, subcontractors and dependent companies downstream. The European Commission has launched a social partner consultation in view of a possible consolidation, recast or revision of the three directives, particularly related to shortcomings and incoherencies of the definitions, but also to anticipation of change and restructurings as well as coverage of all workers (seafarers and public administration) (ETUC 2013).

European Works Councils (EWCs) are quite well known to the general public as a genuinely European body for information and consultation in the workplace. The legislation on EWCs was adopted in 1994 and its provisions were improved through a recast in 2009. Close to 1,000 EWCs are active (ETUI n.d.; ETUI 2014a). An EWC has been established in approximately half of the companies covered by the directive. The Commission has to report on the functioning of the legislation before June 2016.

The European Company Statute or Societas Europaea (hereafter SE) had one of the longest gestation periods of all EU company law initiatives: 30 years between the original proposal in 1970 and the SE legislation in 2001. Since then, a decade of experience with the SE has shown that it is

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practically unknown among the general public and exists in significant numbers in only a few countries (ETUI 2014b).4

After ten years of experience with SEs, we can see that European company law has (however inadvertently) resulted in robust incentives for business to circumvent national institutions of workers' involvement. Statistics (ETUI 2014c; Hans Böckler Stiftung 2014)5 show that more and more companies register as SEs in order to bypass the national rules. This loophole urgently needs to be tackled, otherwise this trend may even accelerate and cause more damage to national industrial relations systems. The German example best illustrates the situation: a company approaching the thresholds of 500 or 2,000 employees which, respectively, make one-third or one-half (i.e. parity) for workers’ representatives in company boards obligatory will be tempted to circumvent these thresholds: it is sufficient to convert to a European Company just before reaching a threshold and, as a reward, the company gets a European label. Through the use of the 'before-and-after' principle the company can so circumvent the German co-determination laws and then continue to grow in size and number of employees without having to respect national regulations. This situation is untenable, unsustainable and unacceptable. The internal market and in particular European company law has offered many advantages for businesses and has given a push for the Europeanisation of companies. However, at the same time, European company law can lead to an erosion of national institutions of workers' involvement. For the European legislator it would be easy to catch up and close the loopholes. It is necessary to close this exit option and to strengthen democracy at work.

The Directive for a European company (SE) with regard to the involvement of employees is insufficient, as it does not ensure the establishment of a European minimum standard of employee board-level representation. Consequently, it does not create a level playing field. If and when participation rights exist beforehand these rights are preserved in principle, however, many workers are discriminated against due to the absence of participation rights. The discrimination is one of the reasons

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4. 319 'normal SEs' existed in October 2014 out of a total of 2234 SEs. Only 57 have workers' board-level representation.

5. A leaflet of the HBS shows a gap such that in Germany alone 53 out of the 135 SEs have more than 500 and 25 more than 2000 employees in 2014, but only 54 SEs in Europe are SEs with participation rights.

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why the approach based on the ‘before and after’ principle must be replaced and a strong plea in favour of a common European minimum standard is needed. Against all expectations, the SE statute has not yet established a European minimum standard, as it is based on the ‘before-and-after’ principle, which itself is based on national provisions. This purely national basis makes the European label look incomplete. The ETUC recently drew conclusions from it and rejected the ‘before-and-after’ principle, asking instead for a European minimum standard for all European company law forms (ETUC 2014a).

The information and consultation framework needs to be strengthened, in particular in view of anticipation of change and restructuring. Information and consultation are the necessary starting point for any other form of participation. Information and consultation are likely to work better in companies where workers’ board level representation is in place, as it normally allows privileged access to early information, or in companies with a cooperative form of social dialogue. Attention should be paid in particular to an early information procedure and stronger consultation rights in order to reach agreement via a meaningful dialogue before a decision can be finalised. No worker should be excluded from the scope of application of the Directive and effective and dissuasive sanctions must imperatively be put in place.

Major changes are necessary: the Community has drawn up an employment strategy based on the concepts of ‘anticipation’, ‘prevention’ and ‘employability’ which are to be incorporated as key elements into all policies likely to benefit employment, including the policies of individual undertakings. The existing legal framework for employee involvement tends to adopt an excessively a posteriori approach to the process of change and does not contribute to genuine anticipation. Dialogue and negotiation at the level where decisions are prepared and effective participation of employees’ representatives are preconditions to anticipate and manage change. In this context it is important that workers’ representatives are empowered and enabled to anticipate and manage change.

The first step back in European company law followed with the introduction of the cross-border mergers (CBM) directive which does not refer to information and consultation rights and undermines the provisions on board-level representation of the SE. It contains provisions to split the registered seat from the administrative (i.e. ‘real’) seat so that companies can abuse this directive in order to transfer their registered
office for fiscal, social and other legal reasons (e.g. letter box companies), whereas the SE in article 7 makes the single seat principle obligatory. The lack of coherence with the SE Directive has to be addressed, in particular the increased threshold (25 per cent vs 33 per cent), the possibility to restrict workers’ board-level representation to 1/3 of the company board and the direct application of standard rules instead of negotiations.

A further important step backward was undertaken with the proposal of the Commission for a draft Directive on a ‘single member limited liability company’ (SUP) to harmonise national company law (on 9 April 2014). The ETUC warned (in a press release the day before) that the European Commission’s draft Directive is a charter for avoiding tax and national labour rules. The ETUC rejects this proposal, opposing in particular the separation of the administrative seat from the registered office, allowing the circumvention of employee board-level representation (ETUC 2014b). While the European Commission presents the Directive as a means of helping small business to trade across the single market, it has to be pointed out that there is nothing to stop large companies from setting up single member subsidiaries to avoid tax and labour regulations. The Directive has major faults in that it a) fails to define the size of company that the Directive applies to, b) allows a company to register its business in a country different from the one in which it actually operates (a provision that facilitates fraud), c) harmonises national regulation in breach of the subsidiarity principle through the establishment of a 29th regime undermining stronger national provisions and d) lacks a European/cross-border dimension. Taken together, the Directive removes almost all references to workers’ rights and would enable larger companies to misuse the legislation and choose a country of registration with lower taxes and less protection for workers. It would also enable businesses in EU member states where worker representation on the board is a legal requirement to avoid national worker representation rules by registering their business in another country where such rules

6. ‘The registered office of an SE shall be located within the Community, in the same Member State as its head office. A Member State may in addition impose on SEs registered in its territory the obligation of locating their head office and their registered office in the same place’ (Ervine 2014: 727).
7. Worker representation on company boards is a legal requirement in many member states, e.g. in Sweden for companies with over 25 employees; Denmark for over 35 employees; the Czech Republic, Slovenia and Slovakia over 50 employees; Netherlands 100; Finland 150; Hungary 200; Austria 300; Germany 500.
do not exist. The proposal generates serious concerns with regard to fiscal evasion, bogus self-employment, letter box companies, workers’ rights and sustainable corporate governance in general. Once adopted, the SUP would constitute a giant step away from the Sustainable Company concept.

3. Rapid Europeanisation of business and delayed Europeanisation of the right to workplace democracy

The new conditions created by globalisation of the economy involving a process of concentrations of undertakings and cross-border mergers constitute a major challenge for employee involvement. The great diversity of rules and practices existing in Member States underscores the need to Europeanise and modernise the existing set of national and European rules in this field, in particular Community legislation on transnational employee involvement. Procedures for participation of employees are often not yet geared to the transnational\(^8\) structure of the entity which takes the decisions affecting those employees. This may lead to different treatment of employees affected by the same decisions within one and the same undertaking or group of undertakings. Decisions which have a potential effect on the entire undertaking or group or at least two Member States are considered to be transnational - including matters which are of importance for the European workforce in terms of the scope of their potential effect or which involve transfers of activities between Member States or cross-border restructuring.

Appropriate provisions must ensure that the employees of Community-scale undertakings – or Community-scale groups of undertaking –

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8. A definition of ‘transnational’ can be found in the 16\(^{th}\) recital of the EWC Recast Directive: ‘The transnational character of a matter should be determined by taking account of both the scope of its potential effects, and the level of management and representation that it involves. For this purpose, matters which concern the entire undertaking or group or at least two Member States are considered to be transnational. These include matters which, regardless of the number of Member States involved, are of importance for the European workforce in terms of the scope of their potential effects or which involve transfers of activities between Member States.’ The fact that the Member State of the managerial decision is different from the one where the employees are affected would qualify such a decision as transnational (European Parliament 2009: 2).
participate properly in decisions which affect them, in particular when and if they are transnational, either taken in a Member State other than that in which they are employed or with potential effects on other Member States. In this particular context the right of employee representatives to be members of, and to vote in, supervisory or administrative company organs is too often still missing. Representatives of recognised trade unions should become members of supervisory or administrative boards regardless of whether they are employees of a company participating in the establishment of employee board-level representation.

The sudden shutdown of the Greek public radio television broadcaster ERT in June 2013 sounded like a wakeup call: Over 2,500 workers were effectively laid off overnight without any information, consultation or participation; even the workers’ representatives on the board were not involved in the decision. The information and consultation rights of the staff had been totally ignored - as a decade ago in the Renault-Vilvoorde case, which led to the adoption of the 2002 Directive establishing a general framework on information and consultation rights.

4. A new ETUC proposal to strengthen good corporate governance in sustainable companies

4.1 Paving the way

The ETUC Secretariat received the mandate of the Athens ETUC Congress 2011 with regard to strengthening their in-depth work on information, consultation and workers’ participation. Half a year later, in December 2011, an ETUC Resolution took up this mandate, suggesting that the EU institutions should be provided with an elaborated ETUC proposal for European standards on workers’ involvement, which should help prevent registration and location of company seats being organised with a view to avoid employees’ board-level representation. One year after the Congress, in June 2012, a project ‘Setting European Standards in Workers’ Involvement’ was launched to analyse the current state of play and to come up with concrete proposals to improve the situation. Following a series of meetings, a progress report was submitted and discussed at the Executive Committee Meeting of 3-4 December 2013 with the aim of guiding the secretariat and agreeing on the next steps to be taken. After further in-depth work, in October 2014 the ETUC
unanimously adopted a resolution calling for a new overarching European framework for information, consultation and board-level participation.

4.2 Cornerstones for more democracy at the workplace

Since the objective of the ETUC resolution ‘Towards a new framework for more democracy at work’ (adopted at the Executive Committee meeting of 21-22 October 2014), namely the Europeanisation and the improvement of employee involvement in European company forms in the context of a modern social market economy and fair competition, cannot be sufficiently achieved by the Member States and can be better achieved at Community level, the Community is challenged to adopt measures to achieve that objective. The new framework would include an adaptation clause and a minimum standard into the SE statute so that workers’ involvement is updated automatically in case the number of employees changes.

Employee board-level participation structures should be a cornerstone of:

— the new Directive establishing a general framework for information, consultation and board-level participation, asking Member States to apply the stakeholder approach and principles of good corporate governance in order to strengthen democracy at workplace;

or

— the revised SE legislation to avoid situations in which the ‘before and after’ principle does not establish a European minimum standard of employee board-level participation in European company forms (such as the SE or European company law instruments such as the Cross-border Mergers Directive, etc.).

The purpose of the new general framework for employee involvement is to establish a European minimum requirement applicable throughout the Community, whilst at the same time not preventing Member States from laying down provisions more favourable to employees at national level. Further development of the internal market and company law must be properly balanced, maintaining the essential values on which our societies and the European Social Model are based and ensuring that
all citizens benefit from economic and social development within the Community.

4.3 Work in progress

In 2012/13 an ETUC expert group on workers involvement dealt with the issue of workplace democracy. One point of discussion was to add an additional layer to the EWC Directive to allow workers’ representatives to introduce employee board-level participation structures in companies covered by the directive (analogous to the provision of the EWC Directive): a request of employees from at least two countries representing the majority of the workforce would trigger the process of establishing significant employee board-level participation in a European supervisory board. In this case the same principles as in the SE would apply: first negotiations have to take place and then subsidiary requirements would apply. The national trade unions should play a central role and the competent European trade union federations (affiliated to the ETUC) a complementary role.

The need for a Europeanisation of company boards was another point of discussion. The employee representatives in the supervisory or administrative company organs must represent employees from the various Member States in a balanced fashion. Where the structure of the undertaking or group of undertakings changes significantly, for example due to a merger, acquisition or division, the existing employee board-level structure must be adapted.

At its first meeting on 29 April 2014 the new ETUC reflection group on workers involvement discussed a proposal for cornerstones for a European minimum standard in the European company (so-called ‘option A’). The proposal on the table was an ‘escalator’ starting with a low proportion of workers’ board-level representation (WBLR) for small enterprises and increasing to higher proportions depending on the size of the company (as well in the monistic as in the dualistic system):

— a low proportion of WBLR (at least a critical mass of two or three representatives to have real influence) could be applied to small companies with 50 to 250 employees (within the company and its direct or indirect subsidiaries);
— a higher proportion (one third) of participation for companies with 250 to 1,000 employees\(^9\) (within the company and its direct or indirect subsidiaries); and

— a robust parity (half of the seats) for big companies with more than 1,000 employees (within the company and its direct or indirect subsidiaries).

At a second meeting on 15th January 2015 some clarifications were introduced: the WBLR-’escalator’ would deal with the proportion and replace the ‘before-and-after-principle’ in the subsidiary requirements (in the Annex, Standard rules, Part 3 Standard rules for participation, referred to in Article 7 of the SE-Directive). It was underlined that the escalator, as part of the fallback positions in the subsidiary requirements, would leave space for negotiations. The escalator should not be understood as an attempt to introduce thresholds, but to have clear rules on the proportion. At the third meeting of the ETUC reflection group on 25 June 2015 the rationale behind the ‘escalator’ and its three steps was discussed. The main objective is to take fully into account from a trade union perspective the broad diversity and the specific variations of the existing systems which have to be integrated in a truly European standard of workers’ board-level representation in European company forms.

5. Conclusion

The financial crisis has clearly shown that a change of paradigm in European company law is necessary. An alternative to shareholder value must be promoted, specifically the vision of a Sustainable Company which is sustainable along each of three dimensions: environmental, social and economic governance. From a trade union point of view, sustainable worker rights and sustainable employment are key components of sustainability which cannot be neglected. Companies cannot be truly sustainable without a sustainable workforce and working conditions.

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\(^9\) In Germany companies with more than 500 employees have third parity, but the DGB demands a reduction to 250 employees; companies with more than 2000 have half parity, however, DGB wants this to go down to 1000.
Strong worker involvement is needed in order to achieve these goals through the effective exercise of worker voice. An efficient articulation in the triangle of information, consultation and the right to board-level representation is a condition for strong and effective workers’ involvement. In this regard it is important to establish and maintain strong links to the TUs, EWCs, WCs, workers representatives and the workforce itself.

The ETUC has shifted its position towards a true European vision of sustainable company law and added an important piece to the mosaic of fundamental rights, the right to board-level representation and participation. The ETUC resolution on a framework for more democracy at work (2014a), completed work by an ETUC expert group on workers involvement and ongoing work by an ETUC workers’ involvement reflection group are components of this historic shift. The nearer the trade union movement comes to achieving the objective of strong and ambitious European standards for worker involvement, the more progress will be made towards Sustainable Companies with sustainable rights and sustainable employment.

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Chapter 9
Workers’ capital, corporate governance and social responsibility

Ieke van den Burg

1. Introduction

A recent Towers Watson overview of pension fund assets worldwide shows that at the end of 2012 pension funds in the 13 major markets (of which the US is by far the greatest and covers more than half of the total volume) own almost USD 30 trillion in assets, which corresponds to more than € 25 trillion (Towers Watson 2013). This amount is almost 80 per cent of the GDP of these 13 countries, and in some countries pension funds own more than GDP (in the Netherlands 156 per cent of GDP). Almost half is invested in equities, which means that, taking the global market capitalization figure of the WFE at the end of 2012 of USD 54.6 trillion, that roughly a third of the stocks worldwide are owned by pension funds (World Federation of Exchanges 2013). Thus it is not exaggerated to say that workers have a large share in capital. But – dispersed and intermediated as it is via pension funds and their asset managers – they are still far from ‘ownership’ of this stock and from exerting influence.

In this chapter I sketch some trends in the direction of a more active ownership by pension funds and other large institutional investors as well as a broader focus than only on profits and shareholder value. These trends make me optimistic about the opportunities and chances for workers and their trade unions and pension fund trustees to increase their influence on corporate behaviour and social responsibility. In a presentation that I gave in the summer of 2011 for trade unionists in a Transatlantic Social Dialogue in Inzell, Germany I introduced ten-plus-one commandments, that in my view are still more than topical and will hopefully be followed up on both sides of the Atlantic.
2. Trends

In the attitude and behaviour of pension funds (and to a certain extent also of other institutional investors like mutual investment funds, sovereign wealth funds and insurance companies) I see two important trends.

The first is that they move from a traditionally very passive to a more active role vis-à-vis the portfolio companies and other asset classes in which they invest. With ‘active’ in this context I do not mean the short term oriented ‘activism’ that hedge funds have displayed in recent years. ‘Passivism’ with the double connotation of ‘more active but peaceful’ may be a better term for the way pension funds deal with their shareholders’ rights, taking into account the fact that for prudential reasons they possess widely diversified portfolios all over the world. An exemption to this is the Norwegian Government Pension Fund Global (often in short called Norges) that invests in equities outside Norway and holds packages of around two per cent of some 60 big European listed companies (NBIM 2011). They target these companies for an active dialogue and their engagement in some cases leads to exclusions of investing in specific companies. Another example of a more active involvement in dialogue and shareholder meetings is how Dutch pension funds and a growing number of other institutional investors coordinate their policies for participation and voting at annual general meetings of shareholders (AGMs) of Dutch corporations through an association called Eumedion. PGGM, the second largest Dutch fund, has announced that it will drastically reduce the number of its portfolio companies. Pension funds are also increasingly participating in collective redress legal actions against fraud, misinformation, mismanagement or other corporate failures, not least against the Wall Street banks that sold them the subprime and other risky securities with which the crisis started.

The second trend is that the originally predominantly Anglo-Saxon approach to corporate governance, embedded in for instance the ICGN (International Corporate Governance Network) and UK and other national codes, is gradually shifting to an approach that is focusing more on the substance and content of companies’ (long-term) strategies: long-

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1. ABP, the largest Dutch pension fund with assets of almost € 300 billion, owns shares in more than 4000 companies worldwide (ABP 2013).
2. See http://eumedion.nl/en
term value instead of short-term share price (ICGN 2009). The original Anglo-Saxon approach based on the so-called ‘principal – agent theory’ did contribute a lot to improve transparency, disclosure and shareholder voting rights, issues that traditionally are considered to belong to good corporate governance (CG). Now it is extended to companies’ ethical, environmental, and social behaviour, their so-called corporate social responsibility (CSR). Pension funds (sometimes triggered by public unrest over irresponsible practices) are defining their ESG (ethical/environmental, social and governance) policies, backed by international guidelines and standards like UNPRI\(^3\) (United Nations Principles for Responsible Investment, the counterpart for investors of the UN Global Compact for the corporate sector) and the Global Reporting Initiative’s GRI-G3 reporting standards.\(^4\) There is also a rising movement to integrate financial and non-financial reporting in order to give investors and other stakeholders more in-depth information relevant for sustainable longer term value creation, instead of only quarterly financial figures.\(^5\) The specific focus and methods of different pension funds and fund managers may differ and range from straightforward exclusion on ethical grounds (e.g. cluster bombs/weapons production, animal welfare, pollution) to intensive dialogue with management and (supervisory) boards of the companies. Topical issues at the moment, in which supervisory boards and independent directors have a major role to play, are the nomination and remuneration of top executives. These are issues in particular where in my view (as described in an article in Transfer) trade union trustees in pension funds and employee representatives in works councils and in company boards can work together and complement each other (Van den Burg 2011).

3. **My ten commandments**

1. Let’s first and foremost make a better use of the potential powers of workers’ capital worldwide: coordination and cooperation within the EU (ETUC) and worldwide (Committee on Workers’ Capital CWC and TUAC) should be reinforced. Individual pension funds only own very minor packages of stock per company (even Norges

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3. See http://www.unpri.org
4. See http://www.globalreporting.org/Home
hardly reaches more than one or two per cent of shares per company); so only together can they make a fist with their total of one third of all equities worldwide!

2. Stimulate individual pension participants (and trade union members) to lobby for responsible behaviour of their pension funds, and not less so of the banks, mutual funds and insurance companies that manage their pensions and savings. The UK ShareAction campaign is a good example of how to mobilise and influence behaviour in the financial sector via campaigning on for instance ‘just pay’ and living wages.

3. Do not focus only on defensive action alert themes such as the WalMart or Sodexo campaigns of CTW and SEIU that of course are important and have proven and still will prove their effectiveness; pension funds’ mobilizing and voting strength should be capable of influencing also pro-actively the broader strategies and policies of companies worldwide with respect to remuneration and compensation, sustainability, supply chain responsibility, or lobbying and political party funding.

4. Strengthen the lobby of pension funds and other long-term oriented responsible investors on major regulatory issues like fighting tax evasion and adapting company and tax law, or reorienting prudential regulation and supervision, as well as accounting and auditing rules from their currently predominantly short-term focus into a direction that better supports and promotes long-term responsible investing.

5. Promote Public Private Partnerships of pension funds with regional and local authorities and governments to invest in the necessary public and social infrastructure (transport, housing, education and healthcare). A win-win situation may be created if governments provide the funds with a hedge against future inflation, which is of major importance for pension funds’ risk management to match their future liabilities. The EU 2020 Project Bond Initiative, recently set up by the European Commission and the European Investment bank to issue infrastructure bonds, is an example to be followed worldwide and at several levels (European Commission 2014).

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6. See: http://shareaction.org
6. Apply ESG policies and norms not only to the equities portfolio and the behaviour of portfolio companies, as is now almost exclusively the case, but also to the other asset categories in which pension funds invest. Real Estate for instance is an interesting asset class, in which financial revenues can be combined with major environmental results: CO2 reduction, transfer to sustainable timber and other materials and energy saving and green buildings. In particular I would very much like to see critical and fundamental ESG attention to what is often entitled as ‘Alternative or Innovative Assets’. This asset class in which pension funds increase their investments covers (among others) private equity (PE), hedge funds and other complex financial products that we got to know in recent years (derivatives, CDOs, etc.). In the PE and venture capital world ESG is gradually becoming an issue. The international organization of PE firms has formulated its own ESG guidelines, which some firms seem to take more seriously and build into a profitable strategy. A win-win situation can be achieved for instance with investing in sectors that defaulted due to preceding catastrophes.

7. Let’s try to develop alternatives for and at least exert much more influence on the financial market service providers that make high profits with pension fund (and corporate) money: the vast number of advisors, law firms, audit firms, proxy voting firms, credit rating agencies and above all the bulge bracket of global investment banks that dominate the top of the market. Goldman Sachs, JP Morgan and the like, but also the Big Four audit firms, the rating agencies (Standard & Poor’s and Moody’s) and the proxy voting and advising agency ISS/Risk that serves both the investors and the portfolio companies, form global oligopolies that the biggest pension funds and listed companies can hardly avoid.

8. Pension funds should explicitly declare their interest in a drastic reform of the financial markets where systemic risks are reduced, where financial institutions are directed back to basics again, where long-term investing is stimulated and short term gains are discouraged through (among other things) a financial transactions tax (FTT), where the regulatory capture of governments and supervisors by Wall Street, London City and the other national financial centres will be broken by a strong international cooperation against moral hazard and too-big-to-fail arrogance and anti-trust measures against the dominant oligopolies. If this would sound too political, the
simple and a-political argument for pension fund trustees is that the funds’ interest is to drastically reduce the huge fees they pay into the financial firms: calculated over the 40-50 years horizon of a future pension every one per cent fee means a 30 per cent reduction of the final pay out of pension benefits after retirement!

9. Trade unions and pension funds should increase their expertise and lobby activities regarding financial markets and banking regulation and forge alliances with other long-term investors, consumer groups and civil society to create some countervailing power to the hugely influential financial lobby in Washington, Brussels, London and elsewhere. Finance Watch in Brussels\textsuperscript{7} is a major step in that direction; a similar initiative across the Atlantic is Better Markets.\textsuperscript{8}

10. Do not expect everything solely from regulation and legislation. There is quite some activity going on in the financial and corporate sector in the field of self-regulation: codes of conduct, guidelines and charters, etc. Don’t throw this all away as being not serious and not sufficiently binding. Serious voluntary commitment to internal standards is often a much more sustainable and reliable basis for intrinsic better behaviour than external norms and sanctions. It is worthwhile to explore the possibilities of self-regulation and to use the position that trade unions and workers inside companies possess, to exert influence on properly executed and monitored self-regulation.

11. My final – extra – eleventh commandment may perhaps sound strange for an ex-politician (who by the way never has stopped being a trade unionist). I added it during the Transatlantic Social Dialogue conference in Inzell, Germany, where I observed that some participants strongly pleaded for mobilizing and organizing activities, but focussed their campaigns predominantly on legislative demands and political lobbying. I have noticed that as well in Robert Reich’s book on the Supercapitalism of our times. Although I share his brilliant analysis about the capture of Congress and the White House by Wall Street, I was surprised about one of his conclusions. He is quite outspoken in not believing in internal reform within the corporate sector towards real corporate social

\textsuperscript{7} See www.finance-watch.org
\textsuperscript{8} See http://www.bettermarkets.com
responsibility. He puts all his stakes on reforming (or revolutionising?) the political democracy that – as he and others have rightly stated - has been overtaken so overwhelmingly by the corporate and financial sector. I would argue that trade unionists and workers through their positions inside these companies, in works councils, sometimes in (supervisory) boards, but also via shareholders’ stewardship, dialogue and engagement of the pension funds in which boards of trustees they participate, have a major chance and challenge to exert considerable influence on changing corporate behaviour and strategies from within. My last recommendation thus would be to fight capitalism in its own quarters and ranks and not to rely exclusively on democracy and politicians!

References


Conclusion: the road ahead to the Sustainable Company

Sigurt Vitols

This conclusion summarises the main contribution of this volume to the current debate on the problem of short-termism and the need for long-term sustainable investment. As this is the third book in the trilogy of Sustainable Company books, it also takes the opportunity to review the contribution of the series as a whole and to outline further work to be done on the ‘road ahead’ to the Sustainable Company.

The primary aim of this volume is to bring a stakeholder point of view into the discussion on long-term investment. As indicated in the introduction to this book, the Great Financial Crisis (GFC) has revived the longstanding critique that financial investors have a tendency towards short-term speculative investments which, if unchecked, will ultimately lead to crisis; this short-termism operates to the detriment of the long-term investments needed to promote ‘high-road’ strategies by companies and to fulfil societal needs. The GFC made clear that the dominant economic reasoning is not at all about efficiently-operating free markets, but rather about the dominance of financial and multinational corporations over the market. What is new about the current debate is firstly its spread beyond one ‘type’ of capitalism (as in the past the debate has been focused mainly in the Anglo-Saxon ‘liberal market’ economies) and secondly the inclusion of the dimension of sustainability, rather than just economic competitiveness.

The first contribution of the volume is to point out the inadequacy of the policy proposals currently being made by the mainstream in Europe. Similar to many national governments and other international organizations, the European Commission has acknowledged that there is currently a serious problem regarding a shortage of long-term investments needed to support ‘smart, sustainable and inclusive growth’ and that measures need to be taken to address this. In the area of corporate governance the main policy initiative of the Commission is the Proposed Directive revising the Shareholder Rights Directive. However,
as the chapter by Johnston and Morrow indicates, the Commission’s proposal has not gone far enough towards what would be needed to support the Sustainable Company, as it is centred mainly on ‘shareholder empowerment’. The chapter by Williamson, while focusing on the UK context with the Kay Review of Equity Markets and Long-term Decision Making, highlights the kind of thinking underlying mainstream analyses of short-termism and the weakness of their voluntaristic policy proposals throughout the world.

The second contribution is to strongly link the dimension of investment time horizons with the issue of sustainability. Habbard’s chapter in particular shows that pension funds, as managers of workers’ retirement savings, should in principle be the class of investor with the greatest ability to invest long-term and with the greatest interest in socially- and environmentally-friendly investments. Given the size of pension fund capital, the reallocation of a relatively small proportion of funds under management could have a major impact by helping develop the mechanisms and critical mass needed for investments in clean energy and sustainable infrastructures. This means that current trends in the organization of the financial system, which include a lengthening of the investment chain, need to be countered as they weaken the exercise of workers’ voice in corporate governance and magnify the tendency of investors to focus on short-term financial performance. The chapter by Klec and Mum as well as the one by Van den Burg further develop this theme and indicate the current state of trade union activism vis-à-vis pension funds, including current best practice and the barriers to the exercise of workers’ voice. Pension funds are thus arguably the most promising class of investor to mobilise for long-term sustainable investment and should therefore be highly prioritised in the policy agenda to promote the Sustainable Company. On the other side of the time horizon scale, the chapter by Botsch shows that financial transaction taxes (FTT) are a relatively simple but at the same time very effective means for discouraging short-term speculative behaviour in the financial system without impeding growth.

While most analyses of short-termism acknowledge that the problem is multi-dimensional whose solution requires a package of policy measures,¹ the third contribution of the book is to broaden the discussion of

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¹ The European Commission for example argues that there is no ‘magic bullet’ for developing and diversifying long-term investment (European Commission 2014: 3).
measures needed above and beyond what the mainstream is proposing. In particular the chapters by Cremers and Kowalsky discuss the role that workers can play, since they are the stakeholder that typically has the greatest interest in the long-run survival of their company, including the development of sustainable production processes and products. Cremers argues that the rights of workers to information on environmental and social matters within the company need to be seriously upgraded so that workers can be a well-informed stakeholder. Workers’ involvement thus becomes part of a strategy to open up decision-making and to make corporations more accountable for their actions. Kowalsky discusses the needs for a far-reaching reform of European legislation to support European minimum standards for worker involvement, a step which the ETUC has called for and is currently developing proposals for. The chapter by Mückenberger also reaches beyond the mainstream focus on investment in publicly-traded company securities by highlighting the role that International Investment Agreements (IIAs) could play; specifically, the European Commission could use its new powers to negotiate IIAs with other countries which define mandatory environmental and social standards in international investment.

By discussing the dimensions and possible solutions to the problem of short-termism in our financial system and corporate sphere, this volume thus rounds out the work of the Sustainable Company series. As outlined in the first book in the series (Vitols and Kluge 2011), long-term sustainability-oriented investment is one of the six key elements of the Sustainable Company. However, along with the reform of company law to strengthen worker participation (Vitols and Heuschmid 2012) it is probably the most difficult among the six to realise, not only because of the complexity of the problem but also because of the political power of those forces opposing fundamental financial reform. As such the topic is worthy of a full volume to allow detailed discussion of the issues.

With this series the GOODCORP expert group has completed its outline not only a ‘vision’ of a stakeholder-oriented alternative to the still-dominant shareholder value model of corporate governance, but also the main policy initiatives that would be needed to move our companies in the direction of greater sustainability. The six core elements of the Sustainable Company – a company commitment to the creation of ‘stakeholder value’ instead of shareholder value, company strategies and roadmaps for sustainability, the exercise of stakeholder voice in corporate governance, the disclosure of social and environmental company informa-
tion, sustainability-oriented remuneration and long-term sustainable investors – are all ‘real’, if in some cases existent only in embryonic form. The action agenda for the ‘road ahead’ to the Sustainable Company thus consists of strengthening these six elements where they exist and of spreading these elements to companies and countries where they do not yet play a role.

Regarding further research, the GOODCORP group is now moving on to a focus on the analysis of worker rights and the exercise of workers’ voice in specific EU Directives. Studies of worker rights under the EU Takeover Bids Directive and the EU Cross-Border Mergers Directive are near completion. Through country and company case studies the effectiveness of different legal rights as well as the need for legal reform and the improvement of practice in specific types of situations have been identified.

In terms of the broader stakeholder community, areas where there is a need for future research includes more specific work concretising more specifically which reforms in the financial system could encourage long-term sustainable investment. Secondly, more work could be done identifying the role that stakeholders other than workers, such as certain types of NGOs, could play in exercising ‘stakeholder voice’ in corporate governance and company affairs. Finally, further work could be done to develop the theory of the stakeholder firm, a task which was addressed in the second Sustainable Company volume by Hagen and Mulder (2012).

An analysis of the current political situation in Europe and elsewhere indicates a rather mixed picture which underlines the urgency for proposing stakeholder approaches to corporate governance such as the Sustainable Company. Since the peak of the GFC in 2008, we have in many ways returned to ‘business as usual’ regarding the power of finance and multinational corporations and their use of neoliberal ideologies to dominate the agenda in the political sphere. Political parties that have traditionally worked closely with trade unions and could support a stakeholder approach to corporate governance have as a whole become weaker rather than stronger at the polls. However, on a positive note, the public at large has become much more critical regarding finance, executive remuneration practices and our current economic institutions. Furthermore, official institutions such as the European Commission, the OECD, and other international organizations have moved away from the euphoric embracement of shareholder value corporate governance
characteristic of the 1990s and early 2000s. A further positive sign is the persistent criticism of the shareholder value model of corporate governance in the academic world. Notable progressive initiatives include: the activities centred around the Research Group on Companies, Markets, Society and the Environment at the University of Oslo, which include the Sustainable Companies project (Sjåfjell 2012); the Modern Corporation Project, run out of the Cass Business School; and the Purpose of the Corporation Project, led by Frank Bold. Notable also is a shift in thought on corporate governance among some of the leaders in the academic mainstream, including Colin Mayer, former Dean of the Said Business School (Mayer 2013) and John Kay, head of the Kay Review of UK Equity Markets and Long-Term Decision. The fact that these critical voices remain loud even though the beginning of the GFC is eight years behind us signals that the crisis of the shareholder value model is real and that a window of opportunity for the Sustainable Company has arrived.

References


2. See http://www.jus.uio.no/english/research/areas/companies/ for details on these activities.
3. For information on this project see: https://themoderncorporation.wordpress.com
4. For more information see: http://www.purposeofcorporation.org/en
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Ieke van den Burg was a trade union staff and executive board member of the FNV, the Dutch Confederation of Trade Unions in the eighties and nineties, and a Member of the European Parliament from 1999 – 2009. From 2011 to 2014, she chaired the Brussels-based NGO Finance Watch and was a member of the European Systemic Risk Board’s Advisory Scientific Committee. She died on 28 September 2014 in Amsterdam.

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