

Chapter 1

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

Andrew Johnston and Paige Morrow

1. Introduction

This chapter¹ 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 'contribut[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

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 Sjøfjell (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, Oisín 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).²

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

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 shareholder 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 information 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 shareholders 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 Leal 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

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’.⁵ 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

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 level⁶ (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.

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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