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The revised Shareholder Rights Directive 2017: policy implications for workers

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Policy recommendations

The Shareholder Rights Directive,¹ which aims to give shareholders a minimum level of rights across the EU, was revised in 2017. In terms of elements that are potentially relevant to employees, the new Directive gives shareholders a say-on-pay, and requires both institutional investors and asset managers to have engagement policies.

It is recommended here that, in addition to pushing for greater employee involvement in setting executive pay, employee representatives should continue to challenge the principle that executive pay should be oriented to the share price, and should push for use of wider metrics linked to sustainability, such as employee skills and satisfaction, which better reflect the long-term interests of the company and its various stakeholders. Finally, trade unions should press Member States with board level employee representation to exercise the option in the Directive to make the shareholder vote on the remuneration policy advisory in order to preserve employee influence on executive pay through the board.

Introduction²

Since the 1990s, corporate governance reform in Europe has been increasingly dominated by the shareholder primacy model of the firm, which places the interests of shareholders above those of other stakeholders. In accordance with this model, the Shareholder Rights Directive was originally adopted in 2007. Its purpose was to strengthen the rights of shareholders in corporate governance by defining minimum rights for shareholders in listed companies across the European Union (EU) (Recital 3).

In April 2014, the European Commission acted in response to the financial crisis and criticisms that the shareholder primacy model encourages short-termism and excessive risk-taking by proposing to amend the Shareholder Rights Directive (European Commission 2014). The amendments aimed to contribute to the long-term sustainability of EU companies, create an attractive environment for shareholders and enhance cross-border voting by increasing

the level and quality of shareholder engagement and creating a better link between pay and performance (European Commission 2014, Explanatory memorandum). The amended Directive came into force on 9 June 2017 and Member States must implement it by 10 June 2019.

This policy brief analyses the evolution and contents of the Directive, and discusses their implications for workers' rights, before making some recommendations as to how trade unions and civil society should respond to the new law. The experience in the United Kingdom (UK) with shareholders' rights is particularly instructive regarding the potential impact of the Directive, as the Directive draws heavily on UK law.

1 Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

2 This policy brief has been prepared partly on the basis of Johnston A. and Morrow P. (2015). The authors thank Sandrine Brachotte for research assistance provided in the preparation of an earlier version.

Where are we now?

The elements of the revised Shareholder Rights Directive that are potentially relevant to employees are reviewed below. In addition, the revised Directive includes provisions relating to the transparency of related party transactions (e.g. a contract with a major shareholder to provide services for the company), the identification of shareholders, as well as the quality and transparency of proxy advisors' recommendations (e.g. to vote for or against a remuneration policy for directors).

Increasing institutional investor and asset manager engagement

One frequent criticism of institutional investors (such as mutual funds) is that they tend not to take an active role in influencing the companies they invest in, through actions like voting and participation in shareholders' meetings, and are mainly interested in short-term share price appreciation. The Directive aims to ensure that institutional investors engage with investee companies, either directly or through asset managers, in order to influence their long-term performance. Institutional investors and asset managers will be required to develop a policy on shareholder engagement, which must cover monitoring, including of the investee company's non-financial performance and reduction of social and environmental risks, dialogue, voting, use of proxy services and engagement with employees and any other stakeholders (Article 3g). The information must be publicly available, at a minimum on the investors' website, along with information about how votes were cast.

Where the institutional investor uses an asset manager, the investor should publicly disclose key elements of its contract with the asset manager, including incentives, how those incentives contribute to long-term performance, and performance evaluations (Article 3h).

The underlying belief is that increasing the engagement of institutional investors and asset managers will allow the 'proper alignment of interests between the final beneficiaries of institutional investors, the asset managers and the investee companies and potentially to the development of longer-term investment strategies and longer-term relationships with investee companies involving shareholder engagement' (Recital 19).³ The Commission's Action Plan, which outlines the Commission's strategy in this area, elaborates that the aim of improving transparency is to increase dialogue between shareholders and companies, promote accountability to civil society and ensure there are proper checks and balances on (supervisory) board oversight (European Commission 2012).

It is unclear that increasing transparency on its own will lead to increased engagement by institutional investors or that end beneficiaries of pension funds, for example, will use this disclosure to put pressure on their fund administrators to take a more active role either directly in relation to investee companies, or indirectly via their asset managers. The UK example is instructive here, as greater transparency alone has not led to significantly increased investor engagement.

³ The terms 'final beneficiary' or 'end beneficiary' refer to the investor (typically an individual or group of individuals) at the beginning of an often-lengthy investment chain.

Furthermore the obligation to disclose both an engagement policy and its implementation applies on a comply-or-explain basis, which means that investors have the option not to comply provided that they explain this omission. An earlier version of the Directive put forward by the European Parliament proposed to make it mandatory to have and disclose an engagement policy.

Increasing asset manager engagement

Institutional investors will be required to disclose, again on a comply or explain basis, how their equity investment strategy aligns with the profile and duration of their liabilities (Article 3h). 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.

It is questionable whether end beneficiaries will actually use this information to create pressure for a longer-term perspective; however, the disclosure requirement may encourage investors to give more consideration to the appropriateness of their investment strategy and mandates given to asset managers.

Furthermore the requirement may begin to address the disparity between the portfolio a long-term investor aspires to hold and that which it actually holds, which may differ significantly due to over-reliance on short-term asset managers (Clark and Monk 2012). This provision may also be useful for stakeholder groups, such as trade unions and civil society organisations seeking to engage with businesses.

Directors' remuneration

The Directive does not impose a cap on directors' remuneration in relation to fixed pay (which was the approach taken in the Capital Requirements Directive 2013/36/EU), but rather gives shareholders the power to vote on remuneration policy at least once every four years and after any 'material change' (Article 9a(5)) and potentially veto a remuneration policy that they oppose (Article 9a(2)). However an important provision in the Directive is that Member States may choose to make the vote advisory and thus not binding (article 9a(3)). This is particularly significant for countries where workers are represented on company boards, since in these companies workers will have a say in various board policies, including remuneration. Reducing the role of the board in remuneration policy by giving a binding (and thus ultimate) vote by shareholders would thus weaken the role of workers in determining company policy. The policy must explain how it contributes to 'the company's business strategy and long-term interests and sustainability', and give full details of fixed and variable pay (Article 9a(6)). The policy must also explain how the pay and employment conditions of employees were taken into account (Article 9a(6)).

Studies on the effectiveness of existing 'say on pay' requirements in the UK and the US suggest that few shareholders vote against pay policies (see Johnston and Morrow 2015: 31). Their primary concern appears to be that pay is not linked to performance, although some investors are expressing concerns about the disparity between executive pay and employee pay.

The main effect of the new regime is likely to be an increase in dialogue between companies and institutional investors before the pay policy is put to a binding vote (Burgess *et al.* 2017). There is not much evidence that institutional investors are objecting to the metrics used by remuneration committees. Proxy Invest's research into the top ten investors who opposed FTSE 350 (i.e. largest 350 listed companies in the UK) remuneration reports in 2014 suggests that the most common reason for voting against the report was lack of transparency. Some, but by no means all, investors are pushing for longer term incentive plans. There is no mention of pushing for wider performance metrics beyond those conventionally intended to incentivise the maximisation of shareholder value (Proxy Insight 2015). As such, the UK's experience with an advisory vote on the remuneration report suggests that it is likely to be, at best, an unreliable mechanism for realigning executive pay with the long-term sustainability of companies.

Correctly aligning management incentives with the long-term interests of companies, and therefore ultimately, their committed shareholders and stakeholders, is crucial to improving corporate governance. From Enron to the financial crisis, poorly aligned incentives have led to corporate failure and enormous social cost. However, while some investors complain that pay packages have become too complex, there are no signs of pressure to abandon alignment of executive and shareholder interests through the short-term share price.

The assumption seems to have been that engaged, long-term institutional investors will be able 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. However, with UK pension fund and insurance companies divesting their equity holdings since 2008 in favour of alternative investments such as hedge funds and private equity which promise higher yields,⁴ there is a danger that these more short-termist shareholders will use their enhanced powers to push for remuneration schemes that prioritise short-term returns.

In addition, the rapid growth in recent years of passive investment funds, such as Exchange Traded Funds (ETFs) (see e.g. Aggarwal and Schofield 2014), which are interested in the performance of an index rather than individual companies, creates the prospect of whole swathes of shareholders not voting,⁵ robotically following proxy service advice or simply voting with management, although there is also evidence that ETFs may add their considerable weight to campaigns by activist shareholders (Appel *et al.* 2016). Further research on the corporate governance implications of the rapid growth in passive investment is clearly needed. In summary, it cannot be assumed that, with long-term interest rates at historic lows, any shareholders will be averse to remuneration regimes which prioritise short-term shareholder return as expressed in the

share price, and, as such, there is a clear danger that the Directive will make the problem worse.

However, Article 9a(3) of the final agreed text allows Member States to provide that the general meeting vote on the remuneration policy will be advisory only. It will be important for Member States whose corporate governance includes employee representatives on company boards to exercise this option in order to ensure that employees retain influence over executive pay.

An earlier version of the draft Directive, which had been approved by the European Parliament, provided for an employee right to express a view (through their representatives) on the company's remuneration policy and on the remuneration report before its submission to shareholders, even in Member States that lack employee representation on boards. It is clearly regrettable that this provision was omitted from the final text.

Shareholder advisory vote on remuneration report

According to the Directive, the annual corporate governance statement should include a remuneration report outlining all benefits in whatever form granted to individual directors (Article 9b(1)). Shareholders will be permitted to vote on the report (Article 9b(4)). The vote is merely advisory but 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.

In the UK, where shareholders have had an advisory vote on the Directors' Remuneration Report since 2003, levels of dissent have not been significant. Since 2013, only 6 out of 1620 FTSE 350 and Small Cap reports have been rejected. The available evidence suggests that this advisory vote has not affected the level of growth of executive pay, although in egregious cases, dissatisfied shareholders have been able to force boards to reconsider their approach (see Petrin 2015: 11-13).

Implications for workers' rights

Executive remuneration remains a significant issue from the perspective of employees and other workers. First, it offends against notions of distributive justice and undermines public trust, given that average FTSE 100 CEO pay in the UK has reached 128 times the average pay of a full-time employee (UK BEIS 2016: 16).

Second, it rests on the notion that only those at the head of the company create wealth, ignoring the collective aspects of wealth creation within large enterprises (Favereau 2014: ch. 4). It is the wider workforce which contributes to the company's performance. Furthermore, as the Kay Review (a high-level, government-sponsored review into the functioning of equity markets in 2012) noted, 'We might ask why it is necessary or appropriate to pay bonuses to the directors of large companies at all. Many people doing responsible and demanding jobs – cabinet ministers, judges, surgeons, research scientists – do not receive bonuses, and would be insulted by the suggestion that the prospect of bonuses would encourage them to perform their duties more conscientiously... In all of these activities, successful performance is inherently rewarding, and the prospect

4 See OECD (2015:120-121), showing that UK institutional investors have, since 2008, been divesting equity holdings and investing in 'other' assets such as private equity, derivatives and structured products in a 'search for yield'.

5 The UK government Green Paper noted that on average 28 per cent of shareholders in FTSE 100 companies did not vote on executive pay arrangements (UK BEIS 2016: 19).

of such a reward provides effective alignment of private and public interest' (Kay 2012: 11.3-11.4).

Such arguments have made little or no headway with policy makers. Apart from stating that the remuneration committee should be 'sensitive to pay and employment conditions elsewhere in the group',⁶ the UK's Corporate Governance Code pays no attention to the incentives or treatment of employees further down the hierarchy. The Directive follows this approach, treating executive pay as a matter arising between the shareholders and the executives, and with no relevance for rank-and-file employees, who – according to this view – simply follow instructions and have no further interest in the success or failure of the enterprise.

Third, as currently structured, remuneration practices frequently create perverse short-term incentives for executives to distribute cash flows to shareholders by means of share buybacks and dividends, reducing investments in R&D and firm-specific human capital, offshoring production wherever possible and so on (Lazonick 2013). In other words, executive pay systematically biases executives to exercise their discretion in favour of shareholders rather than other stakeholders. The result has been stagnating wages but soaring equity prices.

Yet, somehow, the shareholders, who are the principal beneficiaries of a system which serves them so well in the short-term, are expected to correct these dysfunctions and produce better long-term outcomes for everyone. It is difficult to see shareholders voting against pay packages which incentivise leverage, buybacks and high levels of dividend payouts, and indeed, as discussed above, the UK evidence is that they do not. In fact, it would be surprising if hedge funds, which are increasingly influential activist shareholders, voted against pay packages that incentivise exactly the types of action they demand from the executives of the companies in which they have invested. As Cremers *et al.* (2017: 271) note, in the US, hedge funds and other activist investors have been pressing for 'Increasing leverage, returning excess cash to shareholders, selling off non-core corporate assets, and cutting operating costs, together with the replacement of incumbent CEOs and other top executives, especially where the latter attempted to resist the activists' requests.'

The Commission's approach to the issue of executive pay raises concerns for employees as does its approach to shareholder empowerment more generally. The Directive's Recitals insist that shareholder involvement 'is one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors', but hints at the need for balance, by stating that 'greater involvement of all stakeholders, in particular employees, in corporate governance is an important factor in ensuring a more long-term approach by listed companies that needs to be encouraged and taken into consideration' (para 14 of preamble).

However, the Directive does little or nothing to ensure stakeholder involvement in corporate governance. The Council's refusal to accept the recommendations of the Legal Affairs committee of the European Parliament that employees should have input into the

remuneration process, as well as its insistence that executive pay can be effectively governed by shareholders alone, demonstrates that the financial crisis has not fundamentally shifted the EU's approach, and that it continues, despite paying lip service to sustainability, to pursue shareholder primacy.

Moreover, the Directive fits uneasily with legal systems whose board-level employee representation systems already offer employee representatives the opportunity to have input. Whilst the preamble emphasises that 'where applicable' employee representatives already have competence alongside shareholders and boards in determining the form and structure of directors' remuneration, and that 'diversity of corporate governance systems within the Union' must be respected, it also states that it is important that 'shareholders have the possibility to express their views regarding the remuneration policy of the company' (para 28 of preamble); where Member States decide to give a binding vote to shareholders in relation to the remuneration policy, this will effectively give them a veto over decisions of the supervisory board in relation to remuneration.

The enhanced transparency put in place by the Directive in relation to the remuneration policy (paras 29-31 of preamble, Article 9a) might allow other stakeholders to create pressure for a longer-term and more sustainable approach, as well as to insist that remuneration policy incorporates environmental and social factors in the calculation of executive pay. However, in the absence of any formal rights to consultation or to have input into the process, this is unlikely to be effective.

Policy conclusions

Trade unions and other activists should keep up pressure for greater employee involvement in pay setting. Following Brexit, it may be easier to persuade the Commission to depart from the UK model. Meanwhile the UK, the European bastion of shareholder primacy, is increasingly having doubts about its policy. Whilst it is currently considering further strengthening shareholder powers in relation to pay, it is also proposing to require companies to disclose pay ratios; to use soft law to strengthen employee voice; and is consulting on requiring remuneration committees 'to explain to the workforce each year how decisions on executive pay reflect wider pay policy' (UK BEIS 2016: 28-30 and 38; UK BEIS 2017: 19-20 and 34). Whilst UK corporate governance policy is highly unpredictable at present, there is scope for continental trade unions to press for employee representation on remuneration committees.

More broadly, trade unions should continue to challenge the principle that executive pay should be aligned with share price, push for use of wider metrics linked to sustainability, employee skills, R&D etc, which better align with the long-term interests of the company and its various stakeholders. There is little evidence that shareholders will do this. Trade unions should continue to oppose pay packages that give executives short-term incentives to raise the share price, and should work with self-declared long-term and sustainable institutional investors to develop and disseminate alternative performance metrics. In addition, trade unions should scrutinise pay policies, and, in particular, companies' explanations of how employee pay and conditions were taken into account, making public comments

6 UK Corporate Governance Code 2016, Section D.1, supporting principles.

on them and feeding into the public debate about the inequities of current executive pay practices.

Finally, national trade unions should ensure that national governments exercise the option, contained in Article 9a(3) and make the shareholder vote on the remuneration policy an advisory vote, in order to preserve employee influence on executive pay through the supervisory board.

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