COMMENTS

3 October 2014

Comments to the Shareholders Rights Revision

KEY MESSAGES

1 BUSINESSEUROPE **is supportive of the objectives** behind the Commission proposal **but shares a different view on the measures** designed to pursue those objectives.

2 The EU must **uphold the principle of better regulation** in avoiding legislative proposals with a disproportionate impact on competitiveness that add no real value to the single market and growth.

3 It is our view that the **principles of subsidiarity and proportionality have not sufficiently been taken into account** when drafting this proposal.

4 In corporate governance it is essential to **avoid one-size-fits-all solutions**. A **principle-based approach is preferable** because it preserves the flexibility provided for by the existing corporate governance framework, where the *comply or explain* principle remains a central piece.

5 The proposal carries the **risk of blurring the roles and competences between the board and the shareholders** especially in the areas of remuneration and related party transactions.

6 We would recommend the European legislator to reassess this proposal in the light of the above remarks, **further detailed in the comments at annex**.

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BUSINESSEUROPE

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COMMENTS TO THE SHAREHOLDERS RIGHTS REVISION

I. Background

On 9 April 2014, the European Commission presented a proposal to revise Directive 2007/36/EC on shareholders rights and directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings. The Commission stated objective is to improve corporate governance of listed companies by reinforcing shareholder engagement and ultimately strengthen the competitiveness and long-term sustainability of these companies. In the ongoing revision, the Commission proposes to harmonise rules on shareholder identification as well as to strengthen reporting obligations of certain company stakeholders (institutional shareholders, asset managers, proxy advisers). It also introduces for the first time at EU level a shareholder 'say on pay' and additional shareholder oversight on related party transactions.

II. Introduction

Shareholder engagement is one of the key factors to help creating a better corporate culture at European level which will ultimately help stimulating more growth and jobs in Europe.

BUSINESSEUROPE **is supportive of the objectives** behind the Commission's proposal **but shares a different view on the measures** proposed to pursue those objectives.

BUSINESSEUROPE believes that this revision should strive to ensure that being listed on a stock exchange continues to be an attractive way of operating in markets and consequently that Europe remains among its competitors in terms of global listings. This requires taking more account of unnecessary burdens imposed on companies and offering them the flexibility needed to encourage entrepreneurship.

> *'Listed company form' must continue to be an attractive way of operating in markets. Europe must thrive to remain among frontrunners in terms of global listings*

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BUSINESSEUROPE does not agree with the extent of the proposed harmonisation. A **principle-based approach is preferable**, especially in the areas of director remuneration and related-party transactions.

The proposal does not take account of the differences in the existing laws of Member States, which are the product of a long process of fine tuning the balance between legislation and self-regulation. The Commission's proposal would require an overhaul of several Member State systems which have proved to be effective, well-functioning and adaptable to emerging challenges.

In the light of the said differences, BUSINESSEUROPE strongly believes that corporate governance is an area where legislation should be kept to a minimum and where particular emphasis should be given to the **principles of subsidiarity and proportionality**. Moreover, and as the Commission itself recognises "*the challenge is to keep [the] legislation simple – not to go beyond what is strictly necessary to achieve policy goals and to avoid overlapping layers of regulation*" [1] [2].

The different corporate governance systems of the Union "*should not be viewed as an obstacle to free enterprise within a single market, but as a treasure trove of different solutions to a wide variety of challenges that has been experienced and overcome*[3]."

In corporate governance like in football, no single model/tactic is a guaranteed success

It is therefore essential to **avoid one-size-fits-all solutions**. The flexibility provided for by the existing corporate governance framework[4] must be preserved, of which the *comply or explain* principle[5] remains a central piece.

In this context, BUSINESSEUROPE would like to share its main views on the specific elements of the Commission's proposal as well as to put forward some recommendations.

[1] Communication from the Commission to the European Parliament, the Council, the European Social and Economic Committee and the Committee of the regions: Regulatory Fitness and Performance Programme (REFIT).
[2] Strategy strongly linked to the principle of better regulation which is now reflected in the proposed structure of the incoming Commission (see, http://europa.eu/rapid/press-release_IP-14-984_en.htm).
[3] Report of the Reflection Group On the Future of EU Company Law, 5 April 2011, p. 11.
[4] Which takes into account a wide variety of legal systems, ownership and management models and company sizes.
[5] In December 2009, a Riskmetrics Study on the comply or explain principle (with collaboration of BUSINESSEUROPE) concluded there is a broad support for this principle among regulators companies and investors.

III. Comments on specific provisions

1. <u>Shareholder identification (Article 3a)</u>

Communication between company and shareholder is essential to achieve good corporate governance. In order for companies to know who their shareholders are in an increasingly complex holding chain, they need to be able to identify them.

This is why BUSINESSEUROPE welcomes the Commission's initiative to create minimum requirements to facilitate the identification of shareholders. Such harmonisation should aim at providing companies with a useful system whilst avoiding raising costs.

To be able to communicate with their shareholders companies need to know who they are

The proposed text (Article 3a, paragraph 3) establishes that '*neither the company nor the intermediary shall use this information for **any other purpose than the facilitation of the exercise of the rights of the shareholder***'. This seems too narrow since the main aim should be to increase dialogue in its different angles which would be more consistent with a long term perspective. This information can be used not only for the exercise of rights but also to map shareholders and to facilitate communication between the shareholder and the company, especially taking into account a cross-border context. It can also be used to identify moves towards possible takeover bids.

In the framework now proposed, it will also prove difficult for the demanding company to know exactly the status of its identification request and where it lies within the holding chain.

According to Article 3d(1) (on transparency of costs), Member States "*shall allow intermediaries to charge prices or fees"* for certain services related to shareholder identification. This harmonisation **should not mean eliminating existing rights of companies** (in the Member States that foresee it) to obtain this information free of charge.

Recommendations:

- **Further clarification is needed on what would be considered as '*facilitation of exercise of rights*' (Article 3a(3));**
- **For the information to be more useful, one could envisage requiring that it includes the number of shares and voting rights;**
- **The drafting should better reflect that identification is a clear right of the company and not simply a possibility offered by the intermediary;**

- **Companies should be allowed to conserve the information for a longer period than 24 months, for example, to help them detect creeping control and collect evidence.**

2. Transmission of information (Article 3b)

Clarification is needed in Article 3b(1) and (2) regarding the expressions '*information related to their shares*' and '*information related to the exercise of rights flowing from shares*'. Does this information relate to or include any other information other than the one companies have to give their shareholders ahead of the General Shareholder Meeting (e.g. the notice)?

Recommendation:

- **The expressions '*information related to their shares*' and '*information related to the exercise of rights flowing from shares*' need further clarification.**

3. Facilitation of exercise of shareholders rights (Article 3c)

Article 3c(2) of the proposal requires companies to **confirm votes cast** in general meetings (AGM) by or on behalf of shareholders. This requirement presents some technical difficulties because systems differ from Member State to Member State[6].

It is unclear whether the company will have fulfilled its obligations when it has provided the voting confirmation to the investor who has cast the vote/ the intermediary who has done so on his behalf.

Recommendations:

- **Clarification is needed as to when a company has fulfilled its obligation to provide a voting confirmation;**
- **The obligation should take into account the technical challenges faced by companies.**

[6] In Sweden, there is normally no formal counting of votes at an AGM unless requested by shareholders; in the UK votes are transmitted through a Central Securities Depository (CREST) which creates practical difficulties to confirm votes as these are not confirmed until they are cast at the AGM; in France, a system of electronic vote (which would facilitate confirmation) called "Voteaccess" is still in development and it might be too costly for small and mid-caps to use.

4. Engagement of institutional shareholders, asset managers and proxy advisers

BUSINESSEUROPE welcomes the emphasis given to these company stakeholders whose degree of engagement can be essential to the long term sustainability of a company.

Requiring institutional shareholders and asset managers to develop an engagement policy seems reasonable to help achieving the above goal. Nevertheless, the requirement towards institutional investors to disclose the results of their engagement policies (Article 3f(3), first sentence) might be difficult to put in practice. **Measuring the effectiveness of shareholder engagement can be challenging**. Share price of the investee company still remains one of the main indicators to measure performance of a company in general. Environmental, Social and Governance (ESG) factors could eventually be used as well, but these two techniques are not without some shortcomings. Improvements in share prices are normally the result of a multitude of factors, difficult to attribute to the engagement from one shareholder. On the other hand, ESG factors are also difficult to quantify or track. Hence, we do not consider this an appropriate requirement.

BUSINESSEUROPE is **in favour of more transparency from proxy advisers** (Article 3i) whose services play an increasingly decisive role in the way in which a great number of important shareholders engage with companies they are investing in. Nevertheless, the proxy services market is dominated by a small group of players which have their registered office outside of the EU. This means that the requirements proposed in the draft directive vis-à-vis proxy advisers will not cover an important part of this market and therefore the proposal might not achieve the intended results.

Recommendation:

- ❖ **The requirement to demonstrate the results of a specific engagement policy should be deleted.**

5. Remuneration of directors

In BUSINESSEUROPE's view, the main issue at stake should be transparency of the remuneration policy. **Clear, understandable and comprehensive information on remuneration of directors** and its **alignment with the company's long-term strategy** helps boosting confidence in companies and ultimately in the markets. But a balance needs to be reached to avoid triggering negative side effects.

BUSINESSEUROPE has **strong concerns on the overall approach** followed by the European Commission in this new layer of legislation that is now being proposed.

In the past years, efforts have been made, either via legislation or via corporate governance codes, to provide national corporate governance systems with an effective framework which fosters more transparency and shareholder involvement in issues related to remuneration[7]. Shareholders have been reacting positively to these efforts. For example, in France, the first year of application of a 'say on pay' based on a soft approach delivered an average approval rate of 92% regarding specific elements granted to executive directors in the French SBF 120 companies. Also, nowadays a significant number of companies - 91% - have set up a committee in charge of remuneration[8]. These solutions found have been shaped to national specificities (e.g. ownership structure, management structure, company sizes, etc.).

Shareholders trust the board to take the appropriate corporate decisions, and, if they feel that the direction taken is harmful to the future of the company, they hold the last word by being able to dismiss the board. If shareholders express their dissatisfaction with the remuneration policy (via a vote or not) it would be unwise for a board not to address their concerns.

For these reasons, **we do not see the need for EU prescriptive legislation in the area of directors' remuneration**. Besides adding administrative burden, it has the potential to harm European companies' competitiveness in attracting the best talented business leaders.

5.1. Binding – *ex ante* – vote on the policy (Article 9a)

The objective of triggering and stimulating debate within a company on issues related to remuneration of directors **should not mean imposing a uniform rule** across the EU. Companies have different organisational structures and different levels of executive positions. Directors' categories are therefore not uniform so should not be treated similarly.

Remuneration is an essential aspect of recruitment and motivation of directors involving many technical and strategic elements for which shareholders do not necessarily have the needed expertise nor the time to fully understand. They should rather be focused on the bigger picture. For shareholders what is important is to be able to identify how the company is meeting its objectives and responsibilities.

The proposal for a shareholder vote on remuneration policy risks **shifting to shareholders the responsibilities normally in the hands of the board**. It should be up to the board to negotiate and determine director's pay. It should not be for shareholders to vote specific pay levels or vote on pay ratios; otherwise this will result in **inefficient micro-management**.

In addition, the proposal does not seem to take into account the **different corporate models** of management (one tier, two tier or mixed). A requirement to obtain shareholders' binding approval on remuneration policy in the General Meeting would

[7] See, Directors' Remuneration Before and After the Crisis: Measuring the Impact of Reforms in Europe, Roberto Barontini, Stefano Bozzi, Guido Ferrarini and Maria Cristina Ungureanu, 2013, published in Social Science Research Network.
[8] Challenging Board Performance: European Corporate Governance Report, Heidrick and Struggles, 2011, p. 19.

severely weaken the position of a supervisory board in two-tier models[9] which would require a complete overhaul of the current status quo.

> *This proposal must not attempt to shift the competences and the responsibilities from the board to shareholders who do not necessarily have the needed expertise nor the time to supervise complex corporate decisions*

Shareholders (namely institutional) already struggle to have sufficient resources and time to engage with the company they invest in, which is why they turn to specialised services provided by proxy advisors. By transferring the responsibility over remuneration policy to shareholders this proposal will give way to an **added dependence** of the latter **on the services of proxy advisors**.

BUSINESSEUROPE does not see a justification for proposing a binding vote on remuneration policy. This option **did not even gather an unequivocal support from respondents to the 2011 green paper** on corporate governance in listed companies[10]. An advisory vote can be equally effective because the board would not be able to ignore the warning signs from shareholders. Ultimately, opinions diverge considerably on which of the different Member State approaches is the most suitable.

BUSINESSEUROPE also questions the **need for a vote every 3 years** if the board decides that the existing policy is still appropriate. It would be useless and time-wasting to require such a vote.

In case of recruitment of a new board member, the proposal allows for **payment outside the approved policy** (Article 9a(1), second subparagraph), which may be awarded provisionally, but at the same time it requires prior approval by shareholders which becomes confusing. In practice, this exemption is too narrow and offers no flexibility because shareholders still need to approve it. This leaves (newly appointed) competent and qualified CEOs in an unclear position because the contract they negotiated is put into question.

[9] A big part of corporate structures in Europe – 42% – follow the two-tier system (source: *2011 Heindrick and Struggle 'European Corporate Governance Report, p. 11).*

[10] See, European Commission Feedback Statement Green Paper EU Corporate Governance Statement, November 2011, p. 10.

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5.2. Remuneration policy components (ceilings, ratios)

BUSINESSEUROPE **disagrees with the prescriptive level** of the proposed reporting requirements in the draft proposal.

We are opposed to the binding inclusion of **maximum amounts of the total remuneration (ceiling)** in the policy (Article 9a(3), second subparagraph). Flexibility is a key element in negotiating a contract with a new director as well as to reward him/her for an outstanding performance. By determining beforehand the highest amounts payable, not only will the law hinder the parties' fundamental freedom of negotiation, it will also hamper a company's chances to attract the best suited director for its strategy and needs.

In addition, by forcing companies to disclose their pay ceilings a phenomenon of '*race to the top*' might be created in the recruiting market which contradicts the objectives of the draft directive.

The obligation to indicate '*the **ratio** between the average remuneration of directors and the average remuneration of full time employees of the company other than directors and (explain) why this ratio is considered appropriate'* also raises serious questions (Article 9a(3) second subparagraph). The calculation of such ratio alone presents many difficulties in case of multinational companies, whose employees are mostly located in countries with different costs of living which will lead to an unreliable benchmark. Moreover, average remuneration depends on many factors such as company size, sector, strategy, history, organisation, different levels of executive positions and employee categories which would make it time-consuming and costly to determine the exact ratios. The dependency on so many company specific factors will also make it very difficult to compare the ratios of the various companies. This seriously questions the usefulness of such ratios.

Equally important is the fact that these requirements remain largely untested. To our knowledge, only two countries have adopted these items without any tangible results. In the US the ratio publication was recently imposed on US companies (details on implementation remain to be approved), and the obligation to indicate maximum and minimum amounts in the policy brought by UK's recent reform have still to present any relevant results.

Before going for new (and untested) legal requirements in corporate governance, the EU should first assess if it works in practice

The requirement to **disclose financial and non-financial performance criteria** to be used and the methods of calculating to which extent directors' performance criteria have been fulfilled should be used with caution. Such criteria (targets) are often linked to confidential business and operational matters of a company, and disclosure might have adverse effects on companies interests and ultimately in the markets. Firstly, making this information public would place it in the hands of competitors. Secondly, if a company decides to adopt a restructuring strategy (e.g. involving a merger, division, asset selling or cost savings), defining the remuneration criteria in accordance, the disclosure of this information might affect the share price of the company.

5.3. Vote - *ex post* - on the remuneration report (Article 9b)

A **principle based approach is preferable when it comes to *say on pay***. It is more beneficial and respectful of national legal systems and different corporate models. This means that it should be left to Member States to decide whether to have a vote *ex ante, ex post* or both as well as the means to implement these votes (law or codes).

To a certain extent, the proposed vote (Article 9b) on the **remuneration report is superfluous** since shareholders will vote on something they previously approved. It might overlap with the vote on the policy.

Because **shareholders are not obliged to explain why** they adopt or reject the remuneration report (it is a YES/NO vote) it is also difficult for companies to assess the motivation/justification of the vote, which might not even be linked to remuneration issues (e.g. opposition to the combination of the functions of CEO and Chairman in the same person).

The proposal also obliges companies to disclose information on remuneration on an **individual pay basis.** Many Member States legislations do not foresee this legal requirement and we have doubts on the need to extend it to all European companies. What is important for shareholders and investors is that directors' pay can attract talented directors while at the same time ensuring that directors' pay is aligned with their responsibilities, duties, work performance and company performance. The development in company performance indicators (revenue, profits etc.) is thus just one of several relevant criteria to determine directors' pay.

Moreover, it is uncertain what the company performance would have been if other directors had been in charge. What can sometimes be perceived as a mismatch between pay and performance might not always be the entire truth. For example, the pay of a particular CEO or executive director can be linked to characteristics of his profile necessary to implement a specific strategy chosen for the company. This strategy might not be suited for early disclosure (e.g. avoid giving advantage to competitors) and it might even not guarantee positive results in the short run (e.g. restructuring, merger or acquisition).

Last but not least, the benefit for investors to know the level of pay at the individual directors' level rather than at an aggregated director level is questionable when, in any case, investors cannot monitor the performance of each individual director. It should therefore remain a choice for each company or each Member State when it comes to disclosure of pay on an individual basis.

Recommendations:

- **When it comes to say on pay a principle-based approach is preferable;**
- **When establishing a *say on pay* Member States should be free to choose whether this should be an *ex ante* or an *ex post* vote;**
- **A number of prescriptive information requirements (e.g. definition of maximum amounts and ratios; obligation to disclose information on remuneration on an individual basis) should be deleted to avoid imposing costly, non-proportional and inefficient obligations on companies;**
- **The requirements on disclosure of performance criteria (targets) and on how they were applied must include an exception for criteria that are linked to confidential business or operational matters (trade secrets).**

6. Related Party Transactions (RPTs)

RPTs are not per definition an unjustified transfer of value out of the company. They are the normal reality of day-to-day operations in groups

BUSINESSEUROPE does not see a cross-border problem in relation to Related Party Transactions (RPTs) which requires such an intrusive EU action.

BUSINESSEUROPE believes that the proposed rules **interfere with the company law structure of listed entities**, in particular in two-tier and mixed systems, by limiting the autonomy of the executive board. This would also lead to an inevitable blurring of competences and responsibilities within a company and an inappropriate change in the balance of power between board and shareholders in several national systems.

BUSINESSEUROPE also fears that by imposing disclosure requirements on all transactions objectively passing a certain threshold would require the publication of **commercially sensitive information**, placing companies at a competitive disadvantage.

National legislations have widely diverging standards and specific arrangements when it comes to related party transactions[11]. Each Member State has different combinations of measures that together make up the national system to safeguard against abusive related party transactions. The measures are linked to the national legal environment, with rules on RPTs being intertwined with many other aspects of the national corporate governance framework. Introducing an EU one-size-fits-all approach (implying third party opinions, shareholder approval or disclosure of low value

[11] *Corporate Governance Factbook*, OECD, February 2014, p. 63 ss.

transactions) to deal with RPT's interferes unnecessarily with the national set-ups and therefore disrespects the subsidiarity and proportionality principles.

The Impact Assessment accompanying the proposal refers to **just one study from one Member State** according to which 371 out of 1,186 cases of RPTs registered in a period of 3 years were *considered 'likely to lead to unjustified transfers of value to related parties*'[12]. We do not consider this unequivocal evidence of a need for action. In addition, the request that EU rules are adopted in this field gathered **very little support from the respondents to the 2011 green paper on corporate governance**[13].

Article 9c of the draft proposal seems to assume that a transaction with a related party is always objectionable. We would like to stress that related party transactions are not per definition an unjustified transfer of value out of the company. If RPTs are unjustified in nature they are illegal and Member States have rules in place to deal with them. Also, there are already EU-rules ensuring transparency on RPT's. Even if the disclosure does not take place at the time of the transaction, the fact that it will appear in the annual accounts is enough to discourage abuse because of a risk of legal challenge.

6.1 Shareholder vote for transactions of more than 5% of assets

Requiring prior approval by shareholders on transactions representing more than 5% of the companies' assets would seriously delay transactions since convening AGM's takes a serious amount of time and financial resources. Not all transactions allow for such a delay and some may even be cancelled, which is not in the best interest of the company (nor its shareholders). In addition, the fact that this threshold can also be met by aggregating transactions with the same party in a period of 12 months is also problematic. This will make it very difficult for companies to plan ahead and is thus likely to hinder further a company's ordinary business in a manner that is hard to predict.

According to the current draft, minority shareholders would be granted a special form of influence due to the exclusion from voting of the majority shareholder involved. This could lead to atypical situations where a vitally important transaction for the company involving a shareholder holding the quasi-totality of the shares would risk being blocked by a small percentage of shareholders.

Shareholder's approval is only one of the regulatory strategies that national jurisdictions may adopt regarding RPTs, and it is only applied by few. There is **no evidence that this** measure is necessary to have an **efficient system** hence it should not be imposed at EU level.

Moreover, **International Accounting Standards rules already ensure transparency on RPT's** (in the annual accounts) with companies being held accountable to their shareholders when these accounts are discussed in the AGM. This represents a powerful deterrent to any irregular behavior.

[12] See, Commission Impact Assessment, p. 31.
[13] See, European Commission Feedback Statement Green Paper EU Corporate Governance Statement, November 2011, p. 16.

6.2 Day-to-day operations in groups strongly affected

The scope of the proposed rule is too broad as the definition of related parties refers to IAS 24, which **covers a large number of relations beyond the traditional mother and daughter companies' transactions**. Due to this reference, even joint ventures could possibly also fall within the scope of the proposed rules.

Groups of companies, where related parties are the reality of normal day-to-day operations, would be the most affected by the proposed rules. Consequently, group laws in different Member States would require significant changes.

Although the Commission draft foresees an exception for groups of companies (Article 9c(4)), in practice **few groups would be able to benefit from the proposed exception** due to the fact that the exception is only valid for transactions between a parent company (which must be listed) and its wholly owned subsidiary/subsidiaries. This exception leaves out many group structures, for example, where the parent company is not a listed company (e.g. a holding company) or groups where the transaction is carried out between subsidiaries. In BUSINESSEUROPE's opinion, all transactions between group companies should be excluded (as they form part of the day-to-day reality), as well as transactions with associates and joint-ventures.

6.3 Third party opinion: a costly exercise

BUSINESSEUROPE believes that the cost of the '*fairness opinion*' by an independent third party is underestimated. Some of our members **estimate this cost to be ten to twenty times that of the impact assessment**[14].

This proposed requirement is not compatible with the simplification of EU company law conducted in 2007-2013[15] which was based on the recognition that transparency rules combined with rules on liability and sanctions constituted better suited and more modern legislation than burdensome mandatory expert reports and formal approvals.

Recommendations:

- ❖ **The provisions in Article 9c should be deleted leaving regulation of related party transactions a Member State competence in line with the subsidiarity principle;**
- ❖ **Alternatively, the provisions should be made subject to an overall redrafting, changing the current one-size-fits-all approach to a principle-based approach respecting the corporate governance systems of all Member States without imposing disproportionate burdens on companies:**
  - **It is essential that it remains up to Member States to decide if - and to what degree - related party transactions should involve**

[14] The Impact Assessment foresees a range of EUR 2 500 – EUR 5 000 cost for such an opinion, p. 59.
[15] Directive 2009/109 (simplifying 2nd, 3rd, 6th, 10th company law directive), Directive 2009/48 (simplifying the two accounting directives) and Directive 2013/34 (further simplification of accounting rules).

shareholder approval or approval by a special board committee (e.g. a board committee composed by a majority of independent directors), independent third parties/expert reports or whether (and in which circumstances) interested parties may vote or not, or if Member States prefer other safeguards;

- **Transactions within groups of companies as well as transactions between a company and its joint ventures should be exempted;**
- **Member States should not be required to introduce special measures for transactions that are made on terms that independent parties would have reached at arm's length (under market terms), since such transactions do not pose a potential risk of being detrimental to the company due to abuse of power by related parties.**

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