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Encouraging responsible, long-term shareholder engagement

Briefing note on proposed revisions to the Shareholder Rights Directive…and dispelling some myths

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Background

To stimulate sustainable growth and job creation in Europe it is imperative that the €17 trillion in assets under management by the EU's asset management industry and the €12 trillion held by institutional investors in the EU's pensions and insurance sector is invested more responsibly.[i] Improved shareholder engagement and accountability is not a panacea for the problems of short-termism, misaligned incentives and poor corporate governance which are so damaging to the sustainable economic recovery, but is a crucial part of the solution.

ShareAction is the UK's leading charity promoting Responsible Investment (RI). We monitor and engage with investors to encourage effective management of environmental, social and governance (ESG) risks, informed exercise of shareholder rights and greater transparency and accountability to the millions of people whose long-term savings are entrusted to the capital markets. We have closely monitored the introduction of measures in the UK (the Stewardship Code and shareholder votes on remuneration) that are similar to those proposed in this Directive, in particular Articles 3f, 3g and 3h on engagement policies, investment strategies and transparency and Articles 9a and 9b on remuneration.

The UK's measures have catalysed improvements in the behaviour of many institutional investors and asset managers ('investors') and increased acceptance of the idea of RI and shareholder engagement. However they have not been effective in changing the behaviour of a significant proportion of investors due to a lack of enforcement of the 'comply or explain' mechanisms. ShareAction believes that fears concerning possible negative impacts of this Directive have been overstated.

Will these proposals actually lead to any more engaged, responsible investment behaviour?

- **Yes.** Requiring publication of voting records, substantive RI and engagement policies and outcomes that investors know will be scrutinised by civil society, the media and some beneficiaries does encourage more responsible and engaged behaviour. A recent study by Georgetown University found that transparency and public pressure is driving more engaged shareholder ownership in the USA, particularly in mutual funds where voting disclosures are now mandatory.[ii]
- **Much progress has been achieved in the UK since the introduction of the UK's Stewardship Code[iii] in 2010** which clarifies the rights and responsibilities of institutional investors and asset managers. There have been huge improvements in reporting, quality of policies and demand for RI. For example 80% of UK pension fund's Request for Proposals to asset managers now mention ESG[iv] and according to Eurosif there was a 31.8% increase in use of voting and engagement by UK asset managers from 2011-2013[v]. But lack of enforcement of the 'comply or explain' mechanisms means a significant minority is failing to improve.
- **Currently inefficiencies and problems relating to the transmission of information and facilitation of the exercise of shareholder rights throughout the investment chain discourage shareholder engagement.** We have frequently heard investors complain that

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because they do not know if their voting instructions are properly carried out or acknowledged they are reluctant to dedicate more time to considering voting decisions.

Will these proposals place an unnecessary burden on businesses and investors and harm the EU's economic recovery?

- **No. It is entirely possible for investors to improve reporting on their activities without harming their commercial viability or drowning in red tape**. 82% of the 33 largest asset management firms operating in the UK now disclose voting records and 64% disclose reports including qualitative explanation for their voting decisions. 96% now report portfolio turnover rates to clients.[vi] Such disclosures are a matter of making public data the firm already collects and holds internally.
- As disclosure requirements are annual and retrospective, investors will not have to disclose commercially sensitive information at a moment when it could jeopardise private engagements with companies or give competitors too much information about their strategies.
- **Investment service providers who embrace transparency and develop RI capabilities will be in the best position to compete for business from EU and international clients**. The RI asset management market is growing much faster than the wider market. Since 2011 assets under management where ESG is integrated into investment decisions grew by 65% in Europe compared with 22% growth for the overall asset management industry.[vii] In 2012, US$1 out of every US$9 of US assets under professional management was invested in some form of sustainable investment. By 2014 that number increased to US$1 out of every US$6.[viii]
- **These proposals will help achieve sustainable growth in Europe by tackling damaging short-termism, improving corporate governance and improving market efficiency.** Currently markets are inefficient; they do not properly recognise or reward organisations who make long-term plans and investments. Institutional investors with long-term liabilities normally judge performance and award mandates over short-term horizons.[ix] This prevents asset managers from pursuing strategies where benefits are only apparent over the long-term, like engagement. Requiring disclosure of how the investment strategy is in beneficiaries' best interests and matches the duration of liabilities will help overcome these misaligned incentives, although changing the culture and structure of the investment industry is a challenge.
- **Requiring all investors to develop policies on shareholder engagement will tackle the 'free-rider' problem and create a more level playing field;** investors who do not conduct engagement with companies to improve their performance benefit from the actions of investors who do spend time and money doing so, which is unfair and deters engagement.[x]

Will these proposals undermine the ability of member states to retain their own corporate governance traditions and weaken the autonomy of company boards?

- **No. There is no evidence that investors are meddling too much in companies' affairs and preventing boards from fulfilling their role since comparable measures were introduced in the UK**. Asset managers do not want to conduct the day-to-day management of companies, nor do they have the capacity to given the typically high numbers of investee companies in their portfolios.
- Where responsible investors do conduct engagement they typically seek to spread sectorial best practice amongst investee companies on issues such as better reporting or reducing emissions.[xi]
- **The proposals on remuneration will help curb some of the worst excesses but defeats are very rare**. In the UK less than 1% of remuneration proposals have been rejected by shareholders since the 2008 financial crisis;[xii] boards can still offer salaries necessary to attract key staff.

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Will anyone actually use this information?

- **Yes. Ordinary citizens whose money underpins the investment system via pension funds, savings accounts and insurance contracts care deeply about key RI and shareholder engagement issues** although they are put off by the jargon. According to recent UK surveys, 53% think pension funds should do more to ensure "fair" tax policies by investee companies, 51% think pension funds should push for investee companies to pay living wages,[xiii] and 65% would like more information about how their money is invested.[xiv]
- Recent policy initiatives, such as the 2014 EU Directive on non-financial reporting of large listed companies[xv] have focused on making companies more accountable to their shareholders. The logical next step must be for investors, who exercise shareholder rights on behalf of beneficiaries, to enact the same transparency and accountability as they expect from companies.
- **The investment sector may never be dominated by active, engaged consumers.** But the information generated by the transparency requirements in this Directive can be used by an engaged minority of consumers, civil society organisations, the media and academics to scrutinise the investment community for the benefit of all.
- **Improved accountability and transparency is essential to restore citizens' trust in the financial sector.** The market of 'investment products, private pensions and securities' systematically ranks as worst performer in a list of 30 services measured by the European Commission's Consumer Scorecards, particularly on trust and comparability of products.[xvi]

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[i] European Commission, 'GREEN PAPER Building a Capital Markets Union /* COM/2015/063 final', 2015
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[xiii] UKSIF, 'Attitudes to Ownership 2014: Exploring pension fund and public opinion on ownership and stewardship issues', 2014
[xiv] National Association of Pension Funds, 'What do pension scheme members expect of how their savings are invested?', 2014
[xv] Directive 2014/95/EU of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0095

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[xvi] European Commission, 'Consumer Markets Scoreboard Making markets work for consumers 10th edition, June 2014',
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