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BRIEFING PAPER

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Friends of the Earth Europe

actionaid

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global witness

Shareholder Rights Directive

ActionAid, E3G, Friends of the Earth Europe, Global Witness, ShareAction and WWF believe that improving shareholder engagement and accountability is a very important part of achieving a long-term and sustainable financial system, and improving the governance and performance of investee companies.
This Directive must be made more robust with regard to transparency and ESG factors to bring up to the standard of other recent directives, and future proofs it in light of recent global developments and Commission announcements.

1. Background

Since the Commission drafted the legislative proposal of the Shareholder Rights Directive in 2014, significant movements to build a more sustainable financial system within the EU have taken place:

- The Paris Agreement on climate change was ratified by the EU. Article 2 of the Agreement includes a commitment to make 'finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development'.
- The G20 in China welcomed the need for more sustainable finance, and its Green Finance Study Group published high level recommendations to move forward;
- The FSB high level Task Force on Climate-related Financial Disclosures is preparing recommendations;
- The international community adopted the Sustainable Development Goals (2015), which commit the EU and member states to a universal agenda to deliver social, environmental, economic and governance sustainability;

- At the EU level, the **Institutions for Occupational Retirement Provision (IORPs) Directive** was finalized with a mandatory requirement for pension funds to integrate environmental, social and corporate governance (ESG) factors into their risk assessment. This is a very important precedent for the Shareholder Rights Directive;
- The Commission put forward a communication on the Capital Markets Union[1] confirming the creation of an Expert Group to develop a comprehensive European strategy for sustainable finance.
- The Council has declared in June 2016 that corporate respect for human rights is indispensable to achieve the SDGs[2], while it is now widely accepted that the UN Guiding Principles on business and human rights and the OECD Guidelines for Multinational Enterprises apply to enterprises in the financial sector, covering the entire range of financial institutions and actors.[3]

European institutions should take advantage of this international momentum on sustainable and green finance to finalise the Shareholder Rights Directive[4] (SRD) in an ambitious way and help align financial flows with key policy objectives such as the Paris Agreement and the Sustainable Development Goals.

2. The need for stronger shareholder engagement

The Commission's objectives within the SRD are to:

- contribute to the long-term sustainability of EU companies
- deliver on the commitment of the renewed strategy on the long-term financing of the European economy[1], and;
- contribute to a longer-term perspective of shareholders which ensures better operating conditions for listed companies.[5]'

Our organisations think our proposed recommendations will help achieve the Commission's objectives, which represent some very important steps in the right direction, as well as the EU commitment to policy coherence for Sustainable Development.

The current lack of adequate transparency between companies and shareholders as well as short-term tendencies of companies is widely known to create considerable risks to the economy and damages both European companies and the economy as a whole – it is therefore unsustainable. We believe that equipping shareholders with sufficient information is essential for holding companies' boards and management to account, thus enhancing the long-term success and sustainability of European companies and the effective functioning of capital markets.

Several recent corporate governance scandals have both highlighted the need for better scrutiny and engagement by shareholders and the financial risk to them when things go wrong. For example the VW emissions scandal, the share price is still 11% lower than before the scandal and coalitions of shareholders are now suing the company[6]. However since the scandal broke, many investors have revealed that they were concerned about governance at VW; but they failed to act in time. It's a similar story with BP and the Gulf of Mexico spill which destroyed the share price – there were many warning signs before those investors failed to act on and are now paying the price.[7]

Shareholder engagement or influence requires that an institutional investor understand and attempt to influence the environmental, social and governance (ESG) performance of an organisation through

[1] COM (2016) 601 final
[2] Council conclusions on business and human rights (2016)
[3] OECD (2014), 'Due diligence in the financial sector' and Scope and application of 'business relationships' in the financial sector under the OECD Guidelines for Multinational Enterprises. See also 'ESG toolkit for fund managers'.
[4] We were recently told that progress has been made on the 'Country by country tax reporting' (CBCR) issue that stalled the trialogue of the SRD, with the European Parliament agreeing to discuss it separately in exchange of a more ambitious SRD approach, notably regarding Chapter 1b (Transparency of institutional investors, asset managers and proxy advisors).
[5] European Commission's legislative proposal of the Shareholder Rights Directive
[6] http://www.bloomberg.com/news/articles/2016-09-21/vw-investors-sue-for-8-2-billion-euros-in-germany-over-diesel
[7] BP lost 55% shareholder value after the Deepwater Horizon incident

engagement with management (e.g. by means of dialogue, pressure and support for responsible management) and through the exercise of voting rights. **The inclusion of an explicit reference to environmental, social, governance (ESG) [8] factors,** including in relation to **human rights violations** leading to land-grabs and deforestation, and other negative human rights impacts, and in relation to **due diligence** will help to ensure that investing companies take active steps to avoid contributing, benefitting from or exacerbating **negative ESG impacts. The inclusion of ESG factors are crucial components of sustainable development strategies and are inherently long-term, in the SRD text will encourage investors to take a longer-term perspective in their investments, improve corporate governance and will contribute to a more sustainable financial system in the EU which will also have a knock on effect on their investments in companies outside the EU.**

In addition, companies should pursue long-term strategies, whilst respecting the interests of shareholders and other stakeholders. Steering companies toward taking account of long-term environmental and social sustainability will require important changes to the legal and regulatory framework at the national and EU levels, as well as improvements to business practice, governance and culture. Companies and investors must be aware and assess ESG-related risks as they are material for their financial performance, as demonstrated in several meta-studies[9]. For example, ESG risks can have serious consequences for institutional investors on a financial, reputational and legal level; as such they can also be detrimental to the financial interests of citizens as shareholders, or ultimate beneficiaires of institutional investors.

Investee companies should uphold environmental and social criteria whenever and wherever they operate. EU shareholders hold shares in investee companies both inside and outside the EU that can be found in breach of human rights, involved in deforestation, or through their operations contribute to climate change. This Directive is an opportunity to give shareholders the necessary rights and clarify their obligations so that they can fulfil their responsabilities as owners of capital and contribute to a more sustainable world.

From an investment perspective, the analysis of ESG issues is necessary to make a full assessment of the risks and opportunities associated with particular investments. This should enable investors to make better investment decisions and should facilitate more accurate valuations of businesses by the investment markets[10]. This was a central finding of the Kay Review of UK Equity Markets and Long-Term decision making in the UK[11]. **Greater investor focus on ESG issues should also contribute to a higher quality dialogue between companies and their investors on drivers of long-term value creation**, should incentivise companies to improve their ESG-related governance and management, and should encourage investors to proactively seek out ESG-related opportunities. These actions should, in turn, result in capital being directed towards better governed and managed companies[12], and companies that are better positioned to contribute to the Sustainable Development Goals.

Improving shareholder engagement and accountability is a crucial part of achieving a sustainable financial system that focuses on the long-term. Many shareholders are institutional investors like pension funds and insurance companies with long-term liabilities. However they often use external asset managers to conduct the day-to-day investment management. These asset managers typically are given shorter term mandates and their performance is measured and incentivized on quartlery or annual bases. These misaligned incentives in the investment chain mean that short-term investment strategies are often persued even on behalf of supposedly long-term investors. This is why legislative intervention

[8] We are concerned that without the inclusion of mandatory ESG (environmental, social, governance) factors in the SRD text, the intended shareholder empowerment will not improve corporate governance or contribute to a more sustainable financial system in the EU.
[9] Deutsche Asset Management (2015), ESG & Corporate Financial Performance
[10] UN PRI (2013), Building the capacity of investment actors to use ESG information
[11] The Kay Review in the UK which emphasized 'the important, though not clear-cut, distinction among asset managers between those who "invest" on the basis of their understanding of the fundamental value of the company and those who "trade" based on their expectations of likely short term movements in share price. While some trading is necessary to assist the provision of liquidity to investors, current levels of trading activity exceed those necessary to support the core purposes of equity markets.'
[12] University of Oslo (2016), The Sustainble Companies Project

is needed to overcome the misaligned incentives and require both asset owners and asset managers to develop and disclose policies that show how the investment strategy aligns with the duration of the liabilities and considers ESG issues. These investors should engage with companies by exercising their traditional voting rights responsibly with the aim of increasing the long-term value of their investments[13]. The proper oversight of good governance involves securing the rights of shareholders, and improving transparency so that they can exercise these rights in a responsible, informed and considered way[14].

Some argue that improved transparency is an additional, unnecessary burden on businesses and investors. **However, a strong SRD is necessary to compliment and ensure the effectiveness of the Non-financial Reporting Directive.** Shareholders are the main audience who will use the information that companies are now required to disclose. If shareholders engage with and scrutinize companies on their strategies and performance, including on ESG, a positive feedback loop will be created with companies improving both the quality of their disclosures and consideration given to these issues. This will help ensure more accurate pricing of shares and reward companies who invest in long-term strategies. Furthermore, several studies[15] show that transparency and public pressure are driving more engaged shareholder ownership in the USA. However, investors can relatively easily improve reporting on their voting records because relevant data are already collected internally, so it only means making that data public[16].

Another main barrier is investment advisors (intermediaries), who often have a strong incentive to produce impressive short-term results[17]. If shareholders are encouraged to take a longer term view of their investment then they will have more of an incentive to engage with companies to improve their long-term performance. **It's crucial to put stewardship at the heart of investment decision-making and to encourage investors to have a 'continuous dialogue principle' with their investee companies**, not just when there are problems arising.

Finally, **citizens that have their money involved in the investment system via pension funds, insurance contracts or other ways deeply care about sustainability and shareholder engagement issues**, as shown by several studies[18]. Transparency is vital to restore citizens' trust in the financial sector and ensure that citizens' views are better taken into account by investors managing their money. As these citizens increasing bear some of all of the investment risk associated with these financial products themselves, it is essential that the professionals managing their money have a robust approach for managing risks including ESG and long-term investment strategies.

Recommendations:

- The Shareholder Rights Directive must ensure that investors are equipped to protect and **generate long-term value through effective company monitoring and engagement**. Shareholders play an important role in holding companies' boards and management to account: it should be mandatory for ESG issues to be integrated into shareholder engagement to enhance the sustainability of EU companies and promote long-termism.
- **Investors (asset owners and investment managers) must consider environmental, social and governance (ESG) issues in their investment processes**

[13] George Dallas, Policy Director at International Corporate Governance Network (ICGN) in the Financial Times (2010), Corporate Governance Code

[14] International Corporate Governance Network's (ICGN) (2015), Report on the proposal for a directive of the EP and Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement

[15] Georgetown University McDonough School of Business (2014), 'Influence of Public Opinion on Investor Voting and Proxy Advisors'

[16] ShareAction (2015), Proposed revisions to the Shareholder Rights Directive…and dispelling some myths

[17] European Trade Union Institute (ETUI) (2015), Long-term investment and the Sustainble Company: a stakeholder perspective – Chapter 1 Towards long-termism in corporate governance: the Shareholder Rights Directive and beyond (Andrew Johnston and Paige Morrow)

[18] UKSIF Attitudes to ownership (2014): Exploring pension fund and public opinion on ownership and stewardship issues

and decision-making, and in their engagement with companies. In addition, investors should disclose their active ownership activities (voting, engagement and/or policy dialogue).

- **The Shareholder Rights Directive must ensure that citizens have the information they need to understand whether their money is being invested sustainably and in a responsible way.**

3. Our specific recommendations in the SRD text

The Shareholder Rights Directive (SRD) must explicitly require that investors consider environmental, social and governance (ESG) factors, given the limited attention often paid to these factors.

Our specific recommendations focus mainly on Chapter 1B – Transparency of institutional investors, asset managers and proxy advisors:

Technical recommendations for Recital 11:

Recital 11: Therefore, institutional investors and asset managers should develop a policy on shareholder engagement, which determines, amongst others, how they integrate shareholder engagement in their investment strategy, monitor investee companies, ***including their environmental, social and governance risks,*** conduct dialogues with investee companies ***and their stakeholders*** and exercise voting rights. Such engagement policy should include policies to manage actual or potential conflicts of interests, such as the provision of financial services by the institutional investor or asset manager, or companies affiliated to them, to the investee company. This policy, its implementation and the results thereof should be publicly disclosed ***and sent to the institutional investors' clients*** on an annual basis. Where institutional investors or asset managers decide not to develop an engagement policy and/or decide not to disclose the implementation and results thereof, they shall give a clear and reasoned explanation as to why this is the case. If there's a threat of negative ESG impact, disclosure must be obligatory.

Regarding Article 3f - Engagement policy, institutional investors and asset managers should integrate shareholder engagement into their investment decision-making strategies to be able to create long-term value through effective company monitoring, and have a continuous dialogue principle with their investee companies too. They should be able to exercise their voting rights and publicly disclose their engagement policy on their website. Clear and reasoned justification should be provided in case they don't develop an engagement policy nor disclose its implementation.

Technical recommendations for Article 3f - Engagement policy:

- Article 3f 1(b): monitor investee companies on relevant matters such as strategy, financial performance, capital structure, **assessment and reduction of environmental, social and governance (ESG) impacts and risks.**
- Article 3f 1(c): adopt a **continuous dialogue principle** with investee companies.
- Article 3f 1(d): **exercise voting rights** and other rights attached to shares.
- Article 3f 1(f): cooperate with other shareholders and communicate with other stakeholders of the investee companies.
- Article 3f 2: **manage actual and potential conflicts of interests in relation to engagement**, in particular in the situation where institutional investors or asset managers have business relationship with the investee company.
- Article 3f 3: Institutional investors and asset managers **shall publicly disclose on an annual basis** if and how they cast their votes in the general meetings of the companies concerned and their use of proxy advisors and how their engagement policy has been implemented. The information in paragraph 1, 2 and 3 **shall be available, free of charge,** on the institutional investor's or asset manager's **website**.

- Article 3f 4: Where institutional investors or asset managers must, however, **clearly state that they have not complied with the directive**, along with an **explanation of their preferred solution** and the reasons for this. If there's a threat of negative ESG impact, disclosure must be obligatory.

Regarding Article 3g - Investment strategy of institutional investors and arrangements with asset managers, Member States should ensure that institutional investors publicly disclose (free of charge on their website) how they align their investment strategy with their long-term liabilities and how this contributes to the long-term performance of their assets. They should incentivise asset managers to make investment decisions based on the assessments about long-term performance of the investee company, and show how they incentivise them to engage with investee companies to improve their performance. In the case that none of the above is publicly disclosed or if the investment strategy does not contribute to the long-term performance of their assets, institutional investors should provide a clear and reasoned justification to explain why. Comply or explain' mechanisms are often not properly scrutinized or enforced which significantly reduces the impact of such legislations. The amendment to article 3f 4 strengthens this mechanism.

Technical recommendations for Article 3g - Investment strategy of institutional investors and arrangements with asset managers:

- Article 3g 1: Member States shall ensure that institutional investors **publicly disclose** how the main elements of their **investment strategy are aligned with their long-term liabilities**.
- Institutional investors shall also publicly disclose whether and if so how the main elements of their **investment strategy contributes to the long-term performance of assets (i.e. how they exercise due diligence to avoid ESG risks)**, and **in case it does not** contribute to the long-term performance, **give a clear and reasoned explanation** why this is the case.
- Article 3g 2(c) : institutional investors shall publicly disclose **how they incentivise the asset manager to make investment decisions based on assessments about long-term performance of the investee company** and **how they incentivise the asset manager to engage with investee companies** in order to improve performance in the long-term interest of the institutional investor.
- Where the arrangement with the asset manager does not contain one or more of such elements, the institutional investor shall **give a clear and reasoned explanation** as to why this is the case.
- Article 3g 3: The information referred to paragraph 1 and 2 shall be available, **free of charge, on the website** of the institutional investor.

Regarding Article 3h - Transparency of asset managers, we recommend very similar language as in Article 3g above. Asset managers should annually disclose to the public how they make investment decisions about long-term performance of investee companies, including non-financial performance; what conflicts of interest they had in connection with engagement activities; how they use (if it is the case) proxy advisors for the purpose of their engagement activities; and how the investment strategy and implementation thereof contributes to long-term performance of the assets of the institutional investor. We recommends to delete Article 3h 3(a) and replace it by the obligation to provide clear and reasoned justification in case such information is not disclosed. Reporting on possible ESG risk and action to be taken to avoid this should, however, be compulsory given that this risk may include both considerable financial risks but also legal risks.

Technical recommendations for Article 3h - Transparency of asset managers:

- Article 3h 2(a) : Member States shall ensure that asset managers **annually disclose to the public** whether or not, and if so how they make **investment decisions on the basis of judgements about long-term performance of investee company, including non-financial performance**.

- Article 3h 2(c) : whether or not, and if so, what actual or potential conflicts of interest have arisen in connection with engagement activities and how asset managers deal with them.
- Article 3h 2(d) : whether or not, and if so how, the asset manager uses proxy advisors for the purpose of their engagement activities.
- Article 3h 2(e) : how, overall, the investment strategy and implementation thereof contributes to the lng-term performance of the assets of the institutional investor.
- Article 3h 3: The information referred to above shall be available, **free of charge, on the website** of the asset manager and, in case the asset manager doesn't manage the assets on a discretionary client-by-client basis, it shall also be provided to other investors on request.
- Replace Article 3h 3(a) by: Where the disclosure of such information is not provided, the asset manager shall **give a clear and reasoned explanation** as to why this is the case.

In both Articles 3h and 3i, we consider that proxy advisors and asset managers must ensure when developing strategies and compiling information to provide advice (when dealing with investments in areas facing human rights violations, land grabs and environmental destruction), they have sought information from national/international NGOs, the United Nations and other inter-governmental organisations to avoid exposure to negative ESG impacts.

In reference to Article 3i – Transparency of proxy advisors, we consider that there should be a clarification of what is meant by the 'code of conduct'.

Technical recommendations for Article 3i: Transparency of proxy advisors:

Article 3i 1(a): Member States shall ensure that **proxy advisors refer to the code of conduct which they apply**. Where they depart from any of the recommendations of that code of conduct, they shall declare it, explain the reasons for doing so and indicate any alternative measures adopted. This information, together with the reference to the code of conduct which they apply, shall be published on the proxy advisor's website.

Regarding Article 9a - Right to vote on the remuneration policy, we consider that the following elements should be disclosed: how the remuneration policy is aligned with long-term business strategy and sustainability of the company; ensure the right of shareholders to vote on the remuneration policy at the general meetings; how the pay and employment conditions of employees of the company were taken into account; indicate the financial and non-financial performance criteria and how they contribute to long-term objectives; and how it takes into account the votes and views of shareholders.

Technical recommendations for Article 9a - Right to vote on the remuneration policy:

- Article 9a 1 : Member States shall ensure that shareholders **have the right to vote on the remuneration policy** at the general meeting, and that **such vote is binding**.
- Article 9a 2: The policy shall explain how it contributes to the **business strategy, long-term interests and sustainability of the company**.
- It shall explain **how the pay and employment conditions of employees of the company** were taken into account when setting the policy.
- It shall indicate the **financial and non-financial performace criteria**, including, criteria related to sustainability, business strategy, etc., to be used and explain how they contribute to the long-term objectives.
- The policy shall describe and explain **how it takes into account the votes and views of shareholders** on the policy and reports.

Regarding Article 9b - Information to be provided in the remuneration report and the right to vote on the remuneration report, the information contained in the remuneration report should include an explanation on how the total remuneration is linked to long-term performance, and how the financial and non-financial performance criteria is applied. Shareholders have the right to vote on the

remuneration report and, in case it's negative, companies must engage with them to identify reasons for rejection and should explain how the vote of the shareholders has been taken into account.

Technical recommendations for Article 9b - Information to be provided in the remuneration report and right to vote on the remuneration report:

- Article 9b 1(a) : Remuneration report shall contain an explanation **how the total remuneration is linked to long-term performance**, and information on **how the financial and non-financial performance criteria is applied**.
- Article 9b 3 : Member States shall **ensure that shareholders have the right to vote on the remuneration report** of the past financial year during the annual meeting. Where the shareholders vote against the remuneration report **the company shall explain** in the next remuneration report **whether or not and, if so, how, the vote of the shareholders has been taken into account**.

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