The European call for more shareholders' engagement : state of play and way forward

Gaëtane Schaeken Willemaers

PhD
Avocat
Lecturer at the Université Catholique de Louvain (Belgium), CRIDES

I. Introduction

The financial crisis underlined the importance of shareholders as owners. Rights of ownership and the advantage of limited liability should be considered as being associated with a corresponding duty to seek the achievement of the corporate objective. This is the basis for shareholders' duty to engage, *i.e.* a duty to ensure that value is derived from holdings by dealing effectively with concerns about underperformance. The question of shareholders' engagement became a central point of discussion. It also became a topic on the European agenda. The positive effects of investors' engagement are better risk and resource allocation in the economy as a whole and a strengthening of corporate governance.

This being said, it is a fact that most investors do not invest directly in financial markets. They invest through intermediaries, like asset managers who are subject to MiFID.[1] Asset managers arguably have fiduciary duties towards their clients that could be based on MiFID.[2] That fiduciary relationship between the wider class of institutions acting as owners for ultimate beneficial owners and their end-beneficiaries calls for these investment firms to be involved in corporate governance matters.

This article draws on specific sections of a previous book where the issues at hand were initially discussed.[3] It also considers recent European work supporting the book thesis : the green paper on corporate governance in financial institutions (the Financial Institutions Green Paper),[4] the green paper of the European Commission on the European corporate governance framework (the Green Paper)[5] (the two green papers were followed by public consultations), and the report of the reflection group on the future of European company law (the Reflection Group Report).[6] It first suggests that more and more voices are favouring shareholders' value maximisation with a long-term view as corporate objective. It however slightly qualifies the (global and European) plea for corporate engagement by (primarily) institutional investors. It goes on to summarise some suggestions already made by European bodies for the promotion of long-term commitment by institutional investors and draws the attention to remaining concerns. Lastly, it recommends drafting a European stewardship code for institutional investors, and especially pension funds, insurance companies and other collective investment vehicles. That code should be complemented by a regulation which should require compliance with the code.

This article relies on two assumptions. The first one relates to the ownership structure of European issuers. It is assumed that the institutional investors considered for the purposes of this article are, in practice, in a position to impact the outcome of the voting process in European companies.[7] The second one relates to the protection of minority shareholders in Europe. It is assumed that there are sufficient efficient minority shareholders' protection rights in Member States.[8] These assumptions are obviously important for the effectiveness of commitment to influence corporate decisions in European firms.

II. A considerate approach to shareholders' value maximization with a long-term view

According to the shareholders' primacy model, shareholders' value maximisation is the primary objective of the company as it is the most efficient in a competitive environment with a well-functioning market for corporate control.

This being said, whether to take into account other constituencies with whom the firm has business relationships, and how, became important issues in the context of the financial crisis. Some complained that management was too much focussed on short-term perspectives and financial markets. It is true that the last two decades saw a shift in shareholders' focus from long-term to short-term creation of shareholder value.[9] This was made possible through major developments in capital markets, helping to shorten holding periods, like high frequency trading and automated trading. This created market pressures to, *inter alia*, distribute excess cash. This was exacerbated by the way assets managers' performance is eva-

1 See Decision Technology Ltd Report, at 21. See Directive 2004/39/EC, OJEU, 30 Apr. 2004, L 145/1 (herein MiFID).

2 See art. 19 of MiFID (Conduct of business obligations when providing investment services to clients) and art. 44 of Commission Directive 2006/73/EC, OJEU, 2 Sep. 2006, L 241/26 (Best execution).

3 See G. Schaeken Willemaers, *The EU Issuer-Disclosure Regime – Objectives and Proposals for Reform*, Wolters Kluwer, Alphen aan den Rijn, 2011.

4 European Commission, Green Paper Corporate governance in financial institutions and remuneration policies, COM(2010) 284 final, 2 June 2010, available on the European Commission website.

5 European Commission, Green Paper The EU corporate governance framework, COM(2011) 164 final, 5 April 2011, available on the European Commission website.

6 Report of the reflection group on the future of EU company law, 5 April 2011, available on the European Commission website.

7 See G. Schaeken Willemaers, op.cit., at 116 et seq. (where it is suggested that Europe is moving to a market-oriented blockholder model although companies with controlling shareholders are still a majority).

8 See G. Schaeken Willemaers, op.cit., at 142. See the Green Paper, at 17.

9 Paul Woolley, *Why are financial markets so inefficient and exploitative – and a suggested remedy*, in The Future of Finance - And the theory that underpins it, LSE, at 133.

luated and the incentive structure of fees and commissions that encourages asset managers to seek short-term benefits. It was also associated to specific European regulation, creating a "*regulatory bias*" towards short-termism.[10] To name but a few, the requirement to publish quarterly reports or price sensitive information that do not have an impact on long-term objectives, or accounting standards reading fair value as market value, or some financial regulations or practices, including solvency regulations for insurance firms and pension funds, all point to the direction of short-termism.

In essence, the position advocated in this article could be labeled a "shareholders' value maximisation position with a long-term view".[11] Companies pursuing shareholders' wealth maximisation have a positive effect on overall social wealth as they maximise companies' contribution to society.[12] But they should do so with a long-run orientation that seeks sustainable growth and profits based on responsible attention to the full range of relevant stakeholders' interests. This approach takes all constituencies into account to reflect their respective concerns, be they social, corporate governance-related or environmental, but only to the extent they contribute to the company's long-term value.[13] The UK concept of "enlightened shareholder value" seems to accurately reflect the position of this article. "Enlightened shareholder value" implies "[a]*n obligation on directors to achieve the success of the company for the benefit of the shareholders by taking proper account of all the relevant considerations for that purpose*" including "*a proper balanced view of the short and long term, the need to sustain effective ongoing relationships with employees, customers, suppliers and others ; and the need to maintain the company's reputation and to consider the impact of its operations on the community and the environment*".[14] Compliance with it could be checked by increased disclosure obligations from directors.[15] This idea is also reflected in Dutch law (and the Dutch Corporate Governance Code) where it states that "*the board acts in the interest of the company and of the enterprise that it is associated with*". This concept implies that companies should be run with a long-term perspective and aim at continuity. Dutch courts have intervened in shareholders' resolutions on the basis of this principle and the principle that shareholders must act towards the company in accordance with the standards of "*reasonableness and fairness*". These shareholders' resolutions had been initiated by private equity funds holding around 30 % of the shares in a listed company. They were calling for a break up of the company. Dutch courts instead supported management and directors who favoured a longer-term strategy.[16]

Recent European Commission's initiatives encourage issuers to establish incentives for a longer-term vision, thereby marking a change in the policy trends of the European regulator.[17] The idea to strike the proper balance between short-term opportunism and long-term views is shared by the Reflection Group. This group urges that all European listed companies be enabled (through a directive or a recommendation) to choose to opt for a stakeholder view by a specific clause in their articles of association. It also recommends reviewing European regulations and corporate governance codes to promote or, at least, to facilitate a long-term perspective. In that respect, it suggests in particular that quarterly reports be subject to an opt-out by issuers ; that price sensitive information and disclosures related thereto be better defined ; that the board indicates in its corporate governance report what its long-term objectives are and how it plans to realise them while taking into account at the same time the short-term imperatives.

This being said, engagement should not be seen as uniquely best practice for institutional investors.

If a promotion of commitment implies active engagement on the basis of ownership on a longer-term basis, this does not exclude business models that involve active trading of equities. In particular, all fund managers have the obligation to work within the terms of the mandate agreed with their clients. As long as the investment strategy has been clearly discussed with, and disclosed to, end-beneficiaries, short-term investments should not be prohibited. And any conflict of interests between clients' interests and shareholders' interests should be resolved in favour of the clients', at least where investment firms subject to MiFID are concerned. However, the regulator should not create incentives to pursue short-term horizons or speculative behaviours.[18] Besides, automatic trading based on index became a frequently used technique in institutional investing. And this investment strategy implies a passive attitude in terms of corporate governance monitoring. There does not seem to be unanimous evidence relating to the performance of index funds.[19] However, there could be arguments for index investments. As long as their

10 Idem.

11 *Accord* Michael C. Jensen, *From Conflict to Cooperation for Promotion of the Common Good*, in Bradley R. Agle et al., *Dialogue : Toward Superior Stakeholder Theory*, Business Ethics Quarterly 18 (2008), 153 ; Michael C. Jensen, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, Business Ethics Quarterly 12 (2002), 235, at 245 ; Cynthia A. Williams et al., *An Emerging Third Way ? : The Erosion of the Anglo-American Shareholder Value Construct* (2004) ; Lawrence E. Mitchell, *The Legitimate Rights of Public Shareholders*, 2009. See also, L. Mitchell et al., The Embedded Firm : Labor, Corporate Governance and Finance Capitalism, Cambridge University Press, 2011. See also, S. Wen, The Magnitude of Shareholder Value as the Overriding Objective in the U. K. – The Post – Crisis Perspective, Journal of International Banking Law and Regulation, Vol. 26, No. 7, 2011, at 325.

12 *Accord* Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, Colum. Bus. L. Rev. 109 (2009), 237, at 19 ; Robert C. Clark, *Corporate Law* (Little Brown, 1986) ; John Armour et al., *The Essential Elements of Corporate Law* (2009), at 26.

13 *Accord* Jill Solomon, *Corporate Governance and Accountability*, 2nd edition (John Wiley & Sons, 2007), at 28 et seq.

14 See Company Law Review Steering Group, 2000 : 12. See also, Company Law Review Steering Group, 2001 : 41 and s. 172 of the Companies Act 2006.

15 See s. 417 of the Companies Act 2006 (Contents of directors' report : business review). See for a commentary, John Lowry, *The Duty of Loyalty of Company Directors : Bridging the Accountability Gap through Efficient Disclosure*, The Cambridge Law Journal 68 (2009), 607.

16 See the Stork case decided by the Amsterdam Enterprise Court in 2007, Ondernemingskamer, AZ6440, 17 January 2007.

17 See Commission Recommendation 2009/384/EC, OJEU, 15 May 2009, L 120/22. And see the Green Paper. In addition, there is an ongoing fair value debate in the context of the financial crisis, which certainly calls for more research on the impact of the rule on management behaviour with a view to leading to unambiguous conclusions.

18 See P. Woolley, op.cit. (suggesting the prohibition of over-the-counter trading). See also the US SEC proposed new rule to effectively prohibit unfiltered access and maintain market access control (see Securities Exchange Act Release No. 60684 (18 Sep. 2009), 74 FR 48632 (23 Sep. 2009) ('Flash Order Release')). See also, SEC Issues Concept Release Seeking Comment on Structure of Equity Markets, SEC, 13 Jan. 2010.

19 According to Bloomberg data, difference in performance for twenty exchange-traded funds (following indexes) versus 159 active funds is as follows : returns over twelve months up to October 2009 : -4.1 % for exchange-traded funds, 10.1 % for active funds ; returns from January 2009 to October 2009 : 3.4 % for exchange-traded funds versus 20.1 % for

investment strategy is duly disclosed to clients, index investment funds should not be prohibited. Moreover, it is true that institutional shareholders who do engage in active monitoring do not necessarily pursue long-term shareholder value maximisation as sole objective : [20] this is cause for concern. In that respect, it should be noted that prominent academics believe in the overall positive effect of shareholders' engagement, especially activism exercised by hedge funds.[21] Besides, the conflicting interests of some minority shareholders, like some hedge funds, could be dealt with by proper regulation and should not be an objection to the argument of this article.[22]

Institutional investors should carefully consider whether to engage or not to engage. This decision should be based on their investment objectives.[23] The type of engagement advocated in this article is more likely to apply to long-only funds. Among these long-only funds are life insurance companies and pension funds which are likely to be owners of significant stakes in major companies over an extended period, consistent with the long-term horizons of their business model (as in life insurance) or the underlying beneficiaries (as in pensions). Accordingly, they have at least a presumptive interest in long-term engagement with the boards of companies in which they invest. To be sure, it should never be forgotten that the duty of these institutional investors is to their clients and not to the wider public. This might imply that, even where a fund manager has committed to be active, a decision to sell in a particular instance will have to be taken where this is considered to be the most effective response to concerns about underperformance.

III. State of play of some suggestions for the promotion of shareholders' engagement

Given the above, it is *a priori* important that institutional investors, including their asset managers subject to MiFID, put proper resources into governance and, as the case may be, recognise their own accountability to their end-beneficiaries. The field of investors' responsibilities is much less harmonised at European level than that of shareholders' rights.

This section summarises some suggestions of recent European work, stressing points for deeper future analysis and urging for further European initiatives, where appropriate.

active funds (hence an average of 14–17 % of difference in performance (for this last year) in favour of active funds).

20 See, *inter alia*, Stephen M. Bainbridge, *Investor Activism : Reshaping the Playing Field ?* (2008) ; the studies cited by Peter Cziraki et al., *Shareholder Activism through Proxy Proposals : The European Perspective* (2009), at 6.

21 See Alon Brav et al., *The Returns to Hedge Fund Activism* (2008) ; April Klein et al., *Entrepreneurial Shareholder Activism : Hedge Funds and Other Private Investors*, Journal of Finance 64 (2009), 187 ; Marcel Kahan et al., *Hedge Funds in Corporate Governance and Corporate Control*, University of Pennsylvania Law Review 155 (2007), Marco Becht et al., *Returns to Shareholder Activism : Evidence from a Clinical Study of the Hermes U. K. Focus Fund*, Review of Financial Studies 21 (2008).

22 See in that respect, Arts 9 to 16 of Directive 2004/109/EC, OJ, 31 December 2009, L390/38 (herein the Transparency Directive), relating to disclosure of major shareholding, including shareholders acting in concert ; see also, Directive 2011/61/EU, OJ, 1 July 2011, L 174/1. See also, Iman Anabtawi et al., Fiduciary Duties for Activist Shareholders, 60 Stan. L. Rev. 1255 (2008).

23 *Accord* Financial Reporting Council, The UK Stewardship Code, July 2010.

1. Multiple voting rights and higher dividends

The Reflection Group recommends adopting a European regulation to allow in the articles of association preferential treatment for long-term shareholders, including enhanced voting rights and higher dividends. This is already the case in some Member States. Some allow long-term shareholders to have double voting rights,[24] or companies to decide the number of votes to attach to shares.[25] France, Italy and the Netherlands permit higher dividends to be paid.[26]

But these measures could be counterproductive. They could exacerbate problems associated with majority shareholders and reduce liquidity. Besides, a longer holding does not mean *per se* a higher commitment to corporate affairs. Therefore, a costs-benefits analysis should be made before any European rule is suggested.

2. Increased disclosure from the asset manager

In order to control whether the interests of long-term institutional investors are aligned with those of their asset managers, some recommend having disclosure of : [27]

– investment principles and strategies,

– the costs of portfolio turnover,[28]

– whether the level of portfolio turnover is consistent with the agreed investment strategy,

– the engagement activities with investee companies.[29]

This seems to be reasonable and should be implemented.

3. Better design of fee structures

The design of the management contract between the financial intermediary and the investor influences how the former

24 See France (L. 225-123 of the Monetary and Financial Code).

25 See Sherman & Sterling, ISS and ECGI, Report on the proportionality principle in the European Union, available on the European Commission website.

26 See also Aspen Institute, "*Overcoming Short-Termism*", advocating various' measures to encourage investors to hold shares for longer, including withholding voting rights from new shareholders for a year ; the Dutch advisory committee proposing loyalty bonuses for long-term shareholders, such as increased dividends or additional voting rights after holding a share for four years ; UK former minister for financial services, Paul Myners, suggesting that short-term holders of shares should have inferior voting rights ; Cadbury's previous chairman, suggesting that investors who bought shares in a firm after it had received a takeover bid should not be allowed to vote on the offer (this suggestion was not part of the recent changes to the UK Take-over Code).

27 See P. Woolley, op.cit.

28 High turnover could come at a heavy cost to long-term investors. Active management fees and its associated trading costs based on 100 % annual turnover erode the value of a pension fund by around 1.0 % per annum. Pension funds are having their assets exchanged with other pension funds at a rate of 25 times in the life of the average liability for no collective advantage but at a cost that reduces the end-value of the pension by around 30 %. See P. Woolley, op.cit., at 134.

29 See the Green Paper, at 13. See also, ICGN Shareholder Responsibilities Committee, Call for evidence with regard to model contract terms for agreements between asset owners and their fund managers, 31 January 2010.

manages its client's money. Fee structures based on short-term performance encourage short horizons, as evidenced by the hedge fund industry.[30] Although important improvements have been arguably achieved through public pressure and regulatory reforms, some issues remain to be solved.[31]

4. Promotion of the exercise of the voting right

Some corporate governance codes recommend institutional investors to make actual use of their voting rights.[32] Active monitoring by institutional investors is also encouraged by supranational institutions.[33] Active ownership could also be prompted by creating concrete incentives. The most often cited ones are as follows :

4.1. Disclosure of voting policies and voting records

Institutional investors, or the asset managers that act for them, should explain their voting policies at shareholders meetings.

They should also disclose general information about implementation of their voting policies, *i.e.* how the voting rights have been used (for or against a proposal or abstaining from voting), including a statement whether the full holding was voted or whether some shares were not voted, because they were lent for instance. Disclosure of voting records should take place after each shareholders' meeting.

The European Commission so far has not implemented any measure to that effect. This lack of intervention of the European Commission has been criticised by some academics[34] as well as by a number of asset management associations[35] and international institutions or institutional investors' associations.[36] This article concurs with such critics. As shown by empirical evidence, institutional investors, domiciled in the jurisdictions where some sort of framework of voting reporting has been implemented,[37] show a significantly higher level of voting activity.[38] Consequently, the transparency requirement seems to be an effective tool to incentivise institutional investors to make an active use of their voting rights and mitigate the market failure induced by free-riding. Besides, disclosure of voting policy seems to be the best solution to encourage institutional investors to vote in the interests of their end-beneficiaries, if any. Indeed, it enables end-beneficiaries, if any, to understand what criteria are used to reach decisions under usual circumstances. And it demonstrates a commitment to accountability of institutional investors towards their end-beneficiaries, if any, and shows that conflicts of interest are being properly managed.

The institutional shareholders' community will undoubtedly bear additional costs as a result of mandatory engagement and voting disclosure requirements. Today, these costs are borne by the minority of engaged investors, which may welcome to share the burden with other investors. Spreading the costs over all investors will help address the free-rider issue on this matter. Besides, costs need to be put in perspective with the benefits of improved corporate governance across the EU, and should remain within respectable boundaries as long as the framework provides sufficient flexibility.

Under international pressure and through the forces of global convergence, it is likely that there will be changes with respect to disclosure of voting strategies and records in the near future. The European Commission has committed to review the matter.[39]

4.2. Mandatory voting

One could go one step further by rendering voting mandatory, at least in those institutions and companies that are closely linked to European economic and financial stability. Or there could be a "voting premium" to shareholders who exercise their vote (not to those who abstain from voting).[40]

Although the idea has been discussed in some Member States, including in Germany in the early 2000s, the European Commission has so far refused to oblige institutional investors to exercise their voting rights.[41] It specified that a requirement for institutional investors to systematically exercise their voting rights is not considered desirable as they might simply vote in favour of any proposed resolution to fulfil this requirement without analysing the matter by lack of time. And this might be counter-productive.

30 See P. Woolley, op.cit., at 135 ("[t]*he successful funds are in effect making more in fee revenue than the customers derive in cash returns from their investments*").

31 See Simon C. Y. Wong, *Promising steps on bank pay reforms*, 4 JIBFL 206, 2011.

32 See especially, Principle IV. 4 of the Dutch corporate governance code ; one of the guiding lines relating to Principle 8.5 of the Belgian corporate governance code and Principle E.3 of the UK combined code on corporate governance. See also, Principle 6 of the Code on the Responsibilities of Institutional Investors, issued by the Institutional Shareholders' Committee, November 2009 ; NAPF, Institutional Investment in the UK : six years on (November 2007, London) ; ICGN's Statement of Principles on Institutional Shareholder Responsibilities, available on the ICGN website.

33 See, *inter alia*, Principle II. F.1 of the Principles of Corporate Governance 2004 of the OECD ; Investment Fund Managers as Shareholders, Recommendations for Best Practice on Corporate Governance of EFAMA (previously FEFSI) dated 5 Feb. 2002 ; the United Nations Principles for Responsible Investment.

34 See Klaus Ulrich Schmolke, *Institutional Investors' Mandatory Voting Disclosure – European Plans and US Experience*, 7 EBOR (2006) ; Mathias M. Siems, *Convergence in Shareholder Law* (Cambridge University Press, 2008), at 117 et seq.

35 Notably the German *Bundesverband Investment und Asset Management* and the European Fund and Asset Management Association. See also, the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF).

36 See European Sustainable Investment Forum (Eurosif), press release, 16 Apr. 2009 ; see also, The International Corporate Governance Network (ICGN).

37 See in France and in the Netherlands. Contrary to France and the Netherlands, the UK system is strictly voluntary. For details, see RiskMetrics-Group et al., Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009), at 48 et seq.

38 See RiskMetricsGroup et al., Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009).

39 See Financial Institutions Green Paper referring to a review by the European Commission of "*disclosure by institutional investors of their voting practices at shareholders' meetings*". See also the support from the vast majority of respondents to that green paper. See also Reflection Group Report.

40 See Jose M. Garrido Garcia et al., *Institutional Investors and Corporate Governance : Solution or Problem ?*, in Capital Markets and Company Law, ed. Klaus J. Hopt et al. (2003), at 444.

41 See European Commission, Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union : A Plan to Move Forward* (2003), under the heading *Enhancing Corporate governance Disclosure*.

These incentives to promote the actual exercise of voting rights, where they already exist,[42] led to the emergence of third party proxy advisory firms, like RiskMetrics, Egan-Jones Proxy Services, Glass Lewis & Co., Marco Consulting Group, Proxy Governance, Inc., PIRC, Ethos, Eumedion or Deminor, which offer vote recommendations, corporate governance ratings and sometimes cast votes on behalf of their clients. These firms solve the collective action problem relating to shareholder voting and could be a solution to any remaining apathetic behaviour of shareholders, especially those practicing index investments or those with highly diversified equity portfolios.[43] Their impact is quite significant as their institutional clients, primarily mutual funds and pension plans, even though they might hold relatively small stakes in the companies they invest in, due to regulatory restrictions, have significant stock holdings when compared to other investors. Their influence is substantial especially for investments in foreign companies. This calls for proper regulation as their influence is not free from concerns. The main issues relate to their analytical methodology which does not necessarily take into account firm-specific characteristics, characteristics of national legislation and best practice of corporate governance ; to their conflicts of interest as they often also act as corporate governance consultants to investee companies or advise on shareholders' resolutions proposed by another client ; to the lack of competition in the sector which raises concerns about the quality of the advice and whether it meets investors' needs.[44]

4.3. Removal of regulatory obstacles

There is a need to reduce costs, remove legal obstacles and regulatory barriers that preclude shareholders to actively engage in companies.

Even though the Shareholders Rights Directive succeeded in some respects to facilitate the exercise of shareholders' rights in cross-border investments,[45] some areas remain to be improved. The European Commission recognised the problem, although it remains unclear to what extent its initiatives will result in the drastic reforms that are needed.

4.3.1. The intermediation bottleneck

Existing rules on intermediation discourage active shareholders' involvement. The European Commission was supposed to come up with a recommendation dealing with the particular issues of concern.[46] However, it has not done so yet although it acknowledges in its green paper that it is aware of the difficulties and commits to have a look at this issue in relation to its work on harmonising securities law.[47] Moreover, a recommendation, which is not binding, is probably not the best way to regulate this quite important field. One would be better off with a regulation or a directive.[48] It is a fact that the proxy system organised by institutional investors is not effective.[49] This is important as companies cannot be expected to engage with shareholders if they do not and cannot know who they are. At present, there is too much scope for error and delay. It is currently generally not possible to audit the process and to be sure that vote instructions have reached the issuers. There should be, at the very least, better visibility, audit trails, more decision time and confirmation of investors' vote in a timely way.[50] Various solutions have been thought of.[51] The Reflection Group Report recommends direct casting of votes without intervention of the chain of intermediaries and custodians. The depositary bank, where the direct contact with the multitier financial holding system and the investors takes place, would deliver a certificate in physical or electronic form which would authorise this investor to attend (and vote in) the shareholders' meeting, or cast his vote electronically. The system would be subject to an opt-out by smaller companies. The Reflection Group's view might be in reaction to the reluctance of financial intermediaries to change the situation.[52]

4.3.2. Increased shareholders' identification

The system could be complemented by the possibility for the company to identify all its shareholders, beyond what is provided under the Transparency Directive, and for the sole purpose to be able to communicate with them. It seems that about two thirds of Member States have already granted issuers the right to know their domestic shareholders.[53]

This being said, better knowledge could lead to management entrenchment and help management to better defend themselves against any action by shareholders to challenge their conduct of business. Therefore, the case for further European

42 See note 37 and accompanying text.

43 See the detailed voting guidelines indicating how votes will be cast on the website of RiskMetrics.

44 See D. F. Larcker and B. Tayan, Do ISS Voting Recommendations Create Shareholder Value ?, April 2011, SSRN working paper.

45 See Directive 2007/36/EC, OJEU, 14 July 2007, L184/17 (herein the Shareholders Rights Directive).

46 See Recital (11) of the Shareholders Rights Directive.

47 The European Commission services are currently preparing a draft Directive on legal certainty of securities holding and transactions (Securities Law Directive). The Directive is expected to address, *inter alia*, "*the legal framework governing the exercise of investor's rights flowing from securities through a "chain" of intermediaries, in particular in cross-border situations.*" So far, two consultations were organised in that context. The Directive is scheduled in 2012.

48 *Accord* European Commission, Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union : A Plan to Move Forward* (2003), at 14.

49 See, *inter alia*, Manifest Information Services Ltd., Cross-Border Voting in Europe – A Manifest Investigation into the Practical Problems of Informed Voting across EU Borders, May 2007. See for suggested solutions, Dirk A. Zetzsche, *Shareholder Passivity, Cross- Border Voting and the Shareholder Rights Directive*, Journal of Corporate Law Studies 8(2008), 289 ; Dirk A. Zetzsche, *Virtual Shareholder Meetings and the European Shareholder Rights Directive – Challenges and Opportunities* (2007) ; Jaap W. Winter, *Cross-Border Voting in Europe*, in Capital Markets and Company Law, ed. Klaus J. Hopt et al. (2003).

50 See the answers to the European Commission public consultation in that respect, European Commission, Synthesis of the Comments on the Third Consultation Document of the Internal Market and Services Directorate-General : Fostering an Appropriate Regime for Shareholders' Rights (2007).

51 See SWIFT, ISO 20022 standard messages for Proxy Voting on Swift website. See also, the legal solutions suggested by Jaap Winter in Jaap W. Winter, Ius Audacivus. *The Future of EU Company Law*, in Perspectives in Company Law and Financial Regulation (Michel Tison et al. eds, 2009), at 59. See also the solution by ISS Governance Services to make voting services as part of the custodian's contract and paid for whether or not used.

52 See M. Schouten, *The Political Economy of Cross-Border Voting in Europe*, 16 Columbia Journal of European Law, 2009, 1.

53 For more details, see Market analysis of shareholder transparency regimes in Europe, ECB T2S Taskforce on Shareholder Transparency, 9 December 2010, on the ECB website.

action for shareholders' identification will need to be precisely made.[54]

4.3.3. Facilitation of shareholders' cooperation - Action in concert

Impediments to collective shareholders' engagement should be removed to the extent feasible in order for (institutional) shareholders to be able to work together in connection with corporate governance issues.[55] Under current status, there is a risk that a collective shareholders' engagement be considered as an action in concert from shareholders. And an action in concert triggers disclosure of significant holdings pursuant to the Transparency Directive. Besides, it drives the launch of a mandatory bid pursuant to the Take-Over Directive.[56] However, the OECD Principles of Corporate Governance recommend that "*shareholders, including institutional shareholders should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to the exceptions to prevent abuse*" and further state that effective participation in general meetings "*can be enhanced by developing secure electronic means of communication and allowing shareholders to communicate with each other*".[57] There should be European intervention to eliminate at least the different definitions of action in concert in Member States.[58] Some Member States are however of the opinion that enough concerted action can be performed without triggering the obligation to launch a bid.[59]

The Commission acknowledges in the Financial Institutions Green Paper that clearer and more uniform rules on acting in concert would indeed be beneficial. It also refers to other ways to facilitate shareholders' cooperation, like setting up cooperation *fora* or creating discussion platforms.[60]

4.3.4. Facilitation of proxy solicitation

The rules and formalities for proxy solicitation should allow the activist sponsor to gather support of other shareholders at no prohibitive costs.

The Green Paper suggests a European proxy solicitation system where listed companies would be required to set up a specific function on their website enabling shareholders to post information on particular agenda items and seek proxies from other shareholders.

54 See however some support in Financial Institutions Green Paper, at 17.

55 See for such impediments, *inter alia*, European Commission, Commission Staff Working Document : Report on more stringent national measures concerning Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (2008), at § 18 ; ESME, Preliminary Views on the Definition of "acting in concert" between the Transparency Directive and the Takeover Bid Directive, November 2008 ; Paolo Santella et al., A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in Europe and in the US (2009), at 22 et seq.

56 Directive 2004/25/EC, OJ, 30 April 2004, L142/12.

57 See Principle II. G of the OECD Principles of Corporate Governance ; see also, further to such principle, OECD, DAF/CA/CG(2008)3 of 3 Apr. 2008, Shareholder cooperation or acting in concert ? Issues for consideration.

58 *Accord* ESME, Preliminary Views on the Definition of "acting in concert" between the Transparency Directive and the Takeover Bid Directive, November 2008.

59 See, e.g., the UK FSA position in a letter addressed by Sally Dewar to Keith Skeoch on 19 Aug. 2009.

60 See the Financial Institutions Green Paper, at 16.

4.3.5. No triggering of inside information rules

The Reflection Group recommends coordination between the company and its long-term shareholders to further long-term objectives without triggering rules on sharing of inside information.

IV. European intervention in practice

The suggestion of this article to promote greater engagement from long-term institutional investors calls for the European regulator to intervene. The European intervention suggested here consists of a European stewardship code for institutional investors and of a European regulation essentially mandating compliance with the code.

1. European Stewardship Code

The European Commission should draft a code of conduct/best practice for institutional investors (the European Stewardship Code or the Code). This could be based on the UK stewardship code which sets standards of stewardship to which institutional investors should aspire.[61] The Code should be addressed in the first instance to firms who manage assets on behalf of institutional shareholders such as pension funds, insurance companies, investment trusts and other collective investment vehicles.

The European Stewardship Code should be a complementary to the national corporate governance codes for listed companies. To the extent not already done so, changes to these codes should be made to increase the accountability of boards of directors and encourage them to seek ongoing dialogue with investors.

The Code should be applied on a "comply-or-explain" basis.

Indeed, there should not be any requirement to engage. It is legitimate for some institutions to choose not to engage with companies if that does not form part of their investment strategy, or for other reasons.

The comply-or-explain approach should allow accommodating the various types of institutional investors. Not all parts of the Code will be relevant to all institutional investors. For example, smaller institutions may consider that some of its principles and guidance are disproportionate in their case.

In reporting terms, this should entail providing a statement on the institutional investor's website that contains :

– disclosure as to the short-term or long-term focus and what that essentially entails ; [62] and

– a description of how the principles of the Code have been applied, and disclosure of any specific information required ; or

– an explanation if these elements of the Code have not been complied with and the alternative routes taken, if any. Indeed, as it appears that the overall quality of companies' corporate governance statements when departing from a

61 See the Financial Institutions Green Paper.

62 *Accord* Reflection Group Report.

corporate governance code recommendation is unsatisfactory, it should at least be suggested to describe the solution the institutional investor has adopted in case of non-compliance.[63]

Asset managers should produce their statement to the competent supervisory authority as well. Institutions that manage several types of fund should only make one statement. Each institution should also name in its statement an individual who can be contacted for further information and by those interested in collective engagement.

All this information needs to be readily accessible. The European supervisory authority (ESMA) should list on its website all investors that have published such statements. ESMA should provide a link to the statements.

The Code should enable asset managers' clients to assess how asset managers are acting in relation to the Code. This is important for clients when assessing whether or not to enter into a contract with the asset managers and when monitoring the management mandate. It would permit scrutinisation by clients of managers' reports on engagement.

Disclosures made in relation to the Code will assist companies to understand the approach and expectations of their major shareholders.

They may help investors interested in collective engagement to identify like-minded institutions.

The Code should not be seen as constituting an obligation to micro-manage the affairs of companies. It is not the role of institutional shareholders to second guess the management of the companies in which they have invested.[64] The position on shareholders' engagement advocated in this article does not jeopardise the conventional view that the decision-making power should stay with the board of directors. Shareholders are not generally, nor should they seek to be, in a position to identify and assess specific business risks.

Some observers express doubts about the effectiveness of the comply-or-explain approach to corporate governance[65] even though the comply-or-explain approach is widely supported by regulators, companies and investors.[66]

In that line of thoughts, the following concerns against the proposal of the Code could be raised. Does the market really pay attention to compliance with a code of best practice ? If it does, to what exactly does the market pay attention : to the fact that there is an explanation in case of deviation from the recommendation of the code, whatever its quality, or to the relevance/accuracy of the explanation given ?[67] Are retail investors ready to monitor the due compliance by the institutional investor in which they have invested, giving incentives to institutional investors to comply with the spirit, and not only the letter, of a best practice code ? What, for instance, are end-beneficiaries supposed to do/able to do with the information provided if they cannot react because, say, they are locked into a long-term saving plan for their retirement ? These questions could be summed up into one : what are the incentives for institutional investors to comply with a best practice code recommending them to be engaged in the company they have invested in ? Indeed, compliance by any single institutional investor has a substantial public good aspect to it : the single institutional investor's compliance will only have a marginal effect improving the corporate governance of the issuer in which it invests and the effect that it does have will be spread across the whole investing community. Thus, as compliance by the institution involves various costs, including human and financial costs, it may not be in the interests of the institutional investor's individual end-beneficiaries for it to comply with the recommendation to be engaged.

This market failure can be resolved with appropriate monitoring and deterrent penalties to make effective the comply-or-explain regime advocated under this proposal. In that respect, the following is suggested.

At the market level, monitoring could be done by supervisory authorities, professional associations, the media, analysts or academics. But this solution has its own limits. Indeed, these bodies cannot usually go beyond a mere check of formal compliance : has the institutional investor referred to the specific code which is applicable to it, setting out formally its due compliance or the justifications for non-compliance ? In case of breach of the transparency requirement, these bodies would be likely to impose only reputational sanctions, in the form of a "name and shame", or, as the case may be, administrative sanctions.

At the company level, auditors could be asked to go beyond a mere formal check of compliance and enquire whether the information provided by the institutional investor is correct and accurate. But this would probably have a high cost related to it.

As far as the end-investors are concerned, they might not have the proper incentives and might not be in a position to properly monitor due compliance.

Therefore, there is a need for some other body to provide appropriate monitoring. There should be an independent oversight, to provide an authoritative assessment of whether the information provided is correct, not misleading and accurate, for the benefit of prospective clients and other interested parties. This authority should have the financial means and human capital which would allow it to duly exercise its mission. It should also have the necessary sanctioning powers which would go beyond mere reputational sanctions which rely on the powers of embarrassment.[68]

The European Commission should carry out regular monitoring of the take-up and application of the Code. The content

63 See point 10.2 of the Swedish corporate governance code for listed companies.

64 *Accord* Reflection Group Report.

65 See Sridhar R. Arcot et al., In Letter But Not in Spirit : *An Analysis of Corporate Governance in the UK* (2006) ; Eric Nowak et al., *The (Ir)relevance of Disclosure of Compliance with Corporate Governance Codes – Evidence from the German Stock Market* (2006).

66 Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, available on the European Commission website.

67 See Sridhar Arcot et al., *One Size Does Not Fit All, After All : Evidence from Corporate Governance* (2007).

68 See Financial Institutions Green Paper, at 17 (acknowledging that "*effective and efficient sanctions may be needed in order to change the behaviour of the relevant actors*". However, it is rather cautious and considers that "*any increase in managers' civil or criminal accountability should be examined carefully*". It concludes by saying that "[a]*n in-depth study on this subject should be carried out beforehand*".

of the Code should evolve over time to reflect developments in good engagement practice, in the structure and operation of the market, and the broader regulatory framework. For instance, the UK Stewardship Code is due to evolve further to the work on whether institutional investors should disclose their policies on stock lending, arrangements for voting pooled funds, and the nature of the information to be disclosed on voting records.

In that respect, the Reflection Group Report recommends that the role and actions of institutional investors be analysed and a report on actions and trends be published regularly. On that basis it could be considered whether additional actions would be appropriate including formal rules (v comply-or-explain code of best practice) that could foster a long-term rather than a short-term perspective. Should the voluntary compliance with the Code prove to fail, the European regulator should then consider to adopt a more binding regulation to encourage proper engagement by institutional investors. This possibility should be provided for in the below-mentioned regulation.[69]

Over time, these disclosure requirements should facilitate changes in investors' behaviour, encouraging a more considered and informed use of their rights. Prospective clients and end-beneficiaries should in turn take seriously their responsibility to consider the potential for engagement to add value to their portfolios, in particular over the medium and longer term.

2. Engagement Regulation

Compliance with the Code should be mandated in a regulation, which could also acknowledge the existence of fiduciary duties on the part of investment firms subject to MiFID to the benefit of their clients.

The regulation should in essence urge institutional investors, and especially investment firms subject to MiFID who invest on behalf of end-beneficiaries, to be engaged shareholders, concerned with the corporate governance strengths and weaknesses of the companies they invest in, to balance their natural tendency to be only focussed on short-term performance because they win and lose business on the strength of it.

V. Conclusions

The European Commission recently published two consultations on corporate governance, one of which still subject to public comments at the time of writing. Besides, a group of European academics issued the results of their analysis on similar points.

Each considers ways to promote shareholders' engagement for the long-term performance of companies. This European work was a good opportunity to express the views of the author about the corporate objective and the ways to promote it.

This article first suggested that the corporate objective should be shareholders' maximisation with a long-term view.

It then summarised the suggestions of the European bodies regarding the measures to be taken to encourage shareholders' long-term commitment. It also pointed to the remaining issues that require further consideration before any European rule can be implemented.

Lastly, it concretely envisaged the shape of European Commission's measures.

69 Note the UK position where the Company Act 2006 gives the government power to require institutional investors to disclose how they have voted certain types of shares they own or in which they have an interest. The government has stated that it will only use this power if the voluntary regime of disclosure fails to improve disclosure and after full consultation.

INSTITUT ANDRÉ TUNC
– PANTHÉON - SORBONNE –
UNIVERSITÉ PARIS 1 UNITÉ DE RECHERCHE FÉDÉRÉE
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