EUROPEAN COMMISSION

MEMO

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Corporate governance package – frequently asked questions

See also IP/14/396 and MEMO/14/274

I. Revision of the Shareholder Rights Directive as regards the encouragement of long-term shareholder engagement

Key issues addressed by the proposal:

- Insufficient engagement of institutional investors and asset managers
- Insufficient link between pay and performance of directors
- Lack of shareholder oversight on related party transactions
- Inadequate transparency of proxy advisors
- Difficult and costly exercise of rights flowing from securities for investors

1. Why does corporate governance matter? What is good corporate governance?

Corporate governance is the system of rules, practices and processes by which a company is directed and controlled. Good corporate governance ensures that companies and their management operate within a framework of checks and balances so they are accountable both to their owners and to society at large. Good corporate governance ensures the company's management makes decisions in the best interests of the company and thus significantly contributes to companies' competitiveness and long term sustainability and therefore to economic growth and jobs. Evidence[1] suggests that well-governed companies perform better and are more successful in the long run.

[1] Sustainable investing, establishing long-term value and performance, Deutsche Bank meta study, 2012

2. What is shareholder engagement? Why does it need to be encouraged?

Shareholder engagement is the key role played by the owners of companies to hold company boards accountable and to promote the success of companies in the long term. They can do so by:

- monitoring the company
- exercising their shareholder rights, such as voting or
- by establishing a dialogue with the company to constructively challenge boards and to promote better governance, risk management, etc.

A major part (in some Member States, more than half) of the shares of listed EU companies is owned by institutional investors (pension funds, insurance companies) and managed by their asset managers. Although the interests of many pension fund members and insurance policy holders are long term oriented, institutional investors often do not engage with companies they invest in about their long-term prospects. Share-price movements and the structure and performance of capital market indexes are often more important, although they lead to suboptimal returns for the end beneficiaries of institutional investors and puts short-term pressure on companies. Asset managers investing the assets of institutional investors also often have a short-term focus in their investment strategies. This seems to be rooted, at least in part, in an inappropriate alignment of interests in the investment chain: while the end beneficiaries of institutional investors have an interest in long-term performance, the performance of those who manage their assets – "asset managers" (typically external) is being evaluated on a short-term basis.

Lack of proper accountability and short-term pressure leads to suboptimal governance and prevents companies from creating long-term value and from generating growth.

A better focus on long-term performance by institutional investors and asset managers is likely to result in a more responsible approach to investments, taking the long-term interests of the company into account to increase the value of companies on the long term.

3. Why focus on shareholder engagement?

The European Commission has identified a number of corporate governance shortcomings that have contributed to suboptimal management of companies.

It has made a number of proposals particularly in the financial sector, many of which are now adopted, to improve corporate governance (such as the Capital Requirements Directive IV package now in force – see MEMO/13/690), for instance on the functioning of boards, risk management and remuneration of risk takers in financial institutions.

This proposal focuses on corporate governance shortcomings outside the financial sector that are related in particular to some of the identified weaknesses, particularly at the level of shareholder control. This explains why the proposal focuses on the role of shareholders and why its scope covers all listed companies.

4. What is the EU added value of this proposal?

Shareholdings and activities of listed companies have a strong cross-border dimension. 44% of the market value of EU listed companies belong to foreign (European or other) owners, in particular foreign institutional investors and asset managers. The current regulatory framework inhibits investors from playing a more optimal role in the corporate governance of listed companies across borders, and companies, in turn, do not have the necessary means and information to engage with investors, including those established in other EU Member States. Only EU action can ensure that institutional investors and asset managers, but also intermediaries and proxy advisors from other Member States are subject to appropriate transparency and engagement rules.

Long-term shareholder engagement would contribute to a significant improvement in the performance, profitability and efficiency of the companies with which the investor engages. The proposal would incentivise institutional investors with long-term commitments to provide more "patient", i.e. long-term, capital to companies - this is about keeping shares for longer, whereas engagement is being an "active" owner. It would therefore contribute to an increase in long-term financing of the EU economy. These investors can play a crucial role in complementing the role of banks in providing such long-term financing. It may also help exploit the potential of these investors to act counter-cyclically in times of economic downturn. A substantial part of EU listed companies have cross-border activities. Appropriate standards ensuring a well-functioning corporate governance of these companies with a view to their long-term sustainability are thus in the interest not only of Member States where these companies are based but also of those Member States where they operate. Only common EU action can ensure such common standards.

The proposal has been prepared following three extensive public consultations (2010 Green Paper on corporate governance in financial institutions (IP/10/656 and MEMO/10/229, 2011 Green Paper on the EU corporate governance framework (IP/11/404), 2013 Green Paper on the long-term financing of the EU economy (IP/13/274) and has taken into account the views expressed by stakeholders. Add a sentence on what they say they wanted.

5. How would the proposal increase the level and quality of engagement by institutional investors and asset managers?

The draft Directive would require institutional investors and asset managers to disclose how they take the long-term interests of their beneficiaries into account in their investment strategies and how they incentivise their asset managers to act in the best long-term interests of the institutional investor. This would raise awareness of the importance of this issue and make it transparent whether asset management mandates are based on best practices in this area. The draft Directive would also require institutional investors and asset managers to disclose their engagement policies and how they have implemented them. Once investors establish longer-term relationships, there will be more incentives for them to engage, and engagement actions resulting for example in the improvement of the governance of the company would allow them to increase the value of their investments.

6. Does this mean an obligation to vote or to engage for institutional investors and asset managers?

No. Many of the rules for institutional investors and asset managers would apply on a "comply or explain" basis (see first question below under Recommendation for more details). The Directive would not force any investor to vote or engage if they did not see the benefit of it, since creating such an obligation would most likely lead to strict compliance behaviour without appropriate reflection on how to vote or to engage.

7. Would the publication of investment strategies not create a competitive disadvantage for European investors *vis-à-vis* third country investors?

No. The Directive would list a number of key elements which would have to be published with regard to investment strategies and arrangements with asset managers, such as:

- how the equity investment strategy is aligned with the profile and duration of the liabilities of the institutional investor, and how it contributes to the medium to long-term performance of their assets;
- whether and to what extent the institutional investor incentivises the asset manager to align its investment strategy and decisions with the profile and duration of its liabilities and
- whether and to what extent the institutional investor incentivises the asset manager to make investment decisions based on medium to long-term company performance, including non-financial performance, and to engage with companies as a means of improving company performance to deliver investment returns and
- the targeted portfolio turnover or turnover range.

None of these would involve the disclosure of commercially sensitive information.

8. Why is there a need to regulate directors' remuneration?

The structure and level of executive pay is a key tool to ensure that directors' incentives on how to run a company are aligned with those of the company and its owners. The past years have seen repeated cases of mismatch between executive pay and performance.

Shareholders often face difficulties in being properly informed and in exercising control over directors' pay (i.e. the management of the company).

Today transparency on pay and oversight thereof is insufficient: only 15 Member States require disclosure of the remuneration policy and 11 Member States require disclosure of individual directors' pay. In addition, only 13 Member States give shareholders "a say on pay" through either a vote on directors' remuneration policy and/or report.

In order to be able to hold the management to account, shareholders need information and rights to challenge pay, particularly when it is not justified by long-term performance. The lack of proper oversight on remuneration leads to unjustified transfers of value from the company to directors, as is shown in the Commission's impact assessment accompanying this proposal.

The proposal would increase transparency on pay. It would also give shareholders a right to approve the remuneration policy of the directors every three years and a right to vote annually on the remuneration report explaining the pay packages of directors in an advisory manner.

The experience of Member States demonstrates that there is often an insufficient link between pay and performance where shareholders do not have a "say on pay". For instance, in France and Austria, where shareholders do not have a say on directors' pay, the average remuneration of directors in the years 2006 to 2012 increased by 94% and 27% respectively, although the average share prices of listed companies in these countries decreased by 34% and 46% respectively. While executive pay should not depend only on short-term share price fluctuations, such fundamentally divergent trends are one indicator for a mismatch between pay and performance.

In Italy and Spain, before the introduction of an advisory say on pay in 2011, the average share price in the years 2006 to 2011 went down by 130% and 40% respectively, while the average remuneration of directors of listed companies increased by 29% and 26%. However, since the law was adopted in 2011, the average share price of listed companies has increased by 10% and decreased by 5% respectively, but the remuneration of directors has also increased by 1% and declined by 10%.

Such links between pay and performance are even stronger in Member States where shareholders have a binding say on pay on remuneration policy, since their opinion cannot be overruled by the board of directors.

In Sweden and Belgium, before the adoption of a binding say on pay in 2010 and 2011 respectively, the average share price from 2006 to 2009 and from 2006 to 2011 went down by 17% and 45%, while average pay of directors of listed companies increased by 18% and 95%. However, since the laws were adopted in 2010 and 2011, the share price has increased by 16% and 18% but the remuneration of directors has also increased by 18% and decreased (as a correction) by 10%.

Does the proposal put a cap on remuneration?

No. But it requires companies to put to a vote of their shareholders a remuneration policy which includes a maximum amount of remuneration. This will ensure that companies make a conscious choice as to what is the value of good management for their company. For new recruitments, the company will be able to deviate from the maximum, but only subject to prior or ex post approval by the shareholders.

Does the proposal impose a ratio between average salaries and executive remuneration?

The remuneration policy approved by shareholders shall explain how the pay and employment conditions of employees of the company were taken into account when setting the policy or directors' remuneration by explaining the ratio between the average remuneration of directors and the average remuneration of full time employees of the company other than directors and why this ratio is considered appropriate. This will ensure that companies make a conscious choice and reflect on the relative value of good management for the company and on the interaction between executive pay and a company's general working environment. The policy may exceptionally be without a ratio in case of exceptional circumstances. In that case, it shall explain why there is no ratio and which measures with the same effect have been taken.

What happens if shareholders reject the remuneration policy?

The proposal would require companies to submit their remuneration policy to shareholders for a vote every three years. Executive remuneration can only be awarded or paid if it based on an approved remuneration policy. In view of the significant differences of Member States' company law, it will be for Member States set out in detail how these principles will be complied with and what procedures would need to be followed if shareholders reject the remuneration policy.

Does the proposal take into account the role of supervisory boards in Member States with 2-tier-Board structures?

In Member States with a two tier system the supervisory board plays a very important role and is responsible for the remuneration for the members of the management board. This proposal would not affect the key role of the supervisory board in two tier systems. It would still be the supervisory board that would develop the remuneration policy to be submitted to shareholders for confirmation. Most importantly, it would still be for the Board, on the basis of the policy, to decide on the actual remuneration to be paid. The requirement of a shareholder vote will, in line with the general objectives of the proposal, increase the engagement that the board will seek with its shareholders.

9. Why introduce binding EU rules on pay when corporate governance is regulated on a "comply or explain" basis?

Remuneration is a key aspect of corporate governance where conflicts of interest may arise and a strong control right for shareholders can significantly improve the accountability of boards. Unlike in other areas of Corporate Governance for which soft-law measures remain appropriate, the Commission's efforts to improve governance on pay through soft-law measures (three Recommendations on directors' remuneration, in 2004, 2005 and 2009) have not led to significant improvement in this area. It is therefore necessary to proceed with a more prescriptive approach involving binding rules on remuneration.

10. Is the Commission proposing the same framework as for credit institutions and investment firms?

The Commission does not propose the same framework as for credit institutions and investment firms.

Directive 2013/36/EU, part of the CRD IV package (MEMO/13/690), has introduced, *inter alia*, a maximum ratio of 1:1 between the fixed and the variable component of the total remuneration, with some flexibility provided for shareholders to approve a higher ratio, up to 1:2.

Credit institutions and investment firms pose potential systemic risks and there are potential important prudential considerations to take into account. Therefore, it makes sense to have stricter rules for these institutions and firms than for listed companies more generally. That is why the proposal on the revision of the Shareholders Rights Directive does not propose to govern the amount of remuneration, fixed or variable, of directors of listed companies.

The revised Directive would apply without prejudice to existing legislation and, more particularly, to all listed companies. In addition, the proposal does not prevent Member States from adopting and applying stricter rules.

11. Why is there a need for action regarding related party transactions? Why do you propose to grant shareholders a right to vote on these?

Related party transactions are transactions between a company and its management, directors, controlling shareholders or companies of the same group. These transactions may cause prejudice to the company and their (minority) shareholders, as they may give the related party the opportunity to appropriate value belonging to the company. Thus, adequate safeguards for the protection of shareholders' interests are of the utmost importance.

The proposal would require transparency and an independent third party valuation for important transactions involving 1% of companies' assets and would give shareholders a right to vote on the most important related party transactions involving more than 5% of companies' assets. This would enable shareholders to reject those transactions that are not in their interest. Minority shareholders would in particular be better protected against related party transactions involving the controlling shareholder, as this party would be excluded from the vote.

As institutional investors and asset managers are in most cases minority shareholders, more control rights over related party transactions would improve their ability to exercise control over the management, protect their investments and may incentivise them to take a more responsible approach towards engagement. A mandatory shareholder vote over significant related party transactions would also stimulate companies to engage with shareholders.

Finally, granting shareholders a right to vote on related party transactions would help avoid unjustified transfers of value, which could have a positive effect on the competiveness and sustainability of European companies.

The proposed framework is based on a recommendation from the European Company Law Expert Group of 2011. It is carefully calibrated to avoid creating excessive burden. It applies only to significant transactions, and transactions with fully owned subsidiaries are exempted from the new rules since they do not raise issues of minority shareholder protection. Finally, shareholders can give in advance approval of recurring transactions.

13. What is the benefit of an EU framework for shareholder identification?

The proposal would enable listed companies to identify their shareholders. Current rules subject investors to transparency requirements when they acquire 5% of the voting rights of a company. However, today it is not always possible for companies to identify shareholders under this threshold. According to the new rules, intermediaries holding shares on behalf of shareholders would be required to disclose the contact details of shareholders to companies, if they so requested. Such shareholder identification would allow listed companies to communicate directly with their shareholders and to proactively engage with shareholders and to enter into discussions on relevant issues, including corporate governance matters with shareholders.

14. How would the proposal solve the problem of exercising rights (e.g. voting rights) by shareholders, in particular in cross-border situations?

The proposed Directive would significantly improve the exercise of shareholder rights for all shareholders, including retail shareholders. Many problems arise when there is more than one intermediary between the listed company and the shareholder, especially if these are located in different Member States. The proposal would require intermediaries to transmit the voting information from the shareholder to the company and confirm the vote to the shareholder. Shareholders could therefore be certain that their votes have effectively been cast, including across borders.

15. What are proxy advisors? Why is there a need to regulate them?

Proxy advisors are companies specialised in analysing company disclosures and providing advice for investors on how they should vote at the general meeting of shareholders. As institutional investors and asset managers generally have a large number of companies in their portfolios, proxy advisors play a necessary and important role in providing useful voting recommendations, especially in case of cross-border shareholdings.

The important role of proxy advisors also gives them a key role in improving shareholder engagement. To ensure reliable and high quality recommendations and to enhance trust in such services, the proposal would require proxy advisors to disclose certain information about the ways in which they prepare voting recommendations.

16. Would the new rules impose a supplementary burden and cost for listed companies and their investors?

No. The administrative requirements that would be imposed by the new rules are limited when compared to the potential benefits in terms of increased efficiency and competitiveness of companies and long-term performance of institutional investors.

Most of the costs imposed would be linked to transparency obligations. The costs would be limited and distributed evenly between the different stakeholders affected by the new rules.

Listed companies would be subject to new transparency obligations, the cost implications of which would not be significant (e.g. €500-€1 000 for the publication of a remuneration policy). Where a shareholder vote is foreseen, significant flexibility is offered to Member States to prevent unnecessary costs involved by the organisation of additional general meetings which could potentially involve significant costs.

17. What's next?

The proposal will be submitted to the Council and the European Parliament for their consideration and final adoption. Once adopted, the new Directive would have to be implemented into the laws of all EU Member States.

II. Commission Recommendation on the quality of corporate governance reporting ('comply or explain')

1. What does the 'comply or explain' approach stand for?

The 'comply or explain' principle is a key feature of the application of the corporate governance rules in the EU. Most corporate governance is soft law and guidelines are included in voluntary national codes of conduct. The "comply or explain" approach allows listed companies to depart from a particular recommendation of the applicable national corporate governance code, provided that they explain the reasons for doing so. In this way, it offers companies an important degree of flexibility to adapt their corporate governance to their specific situation, yet encourages them to follow corporate governance best practices.

2. Why is there a need for action at EU level in this area?

Despite gradual improvement in recent years, there are still shortcomings in the way the 'comply or explain' principle is applied. Companies often do not provide appropriate explanations when they depart from corporate governance codes. This makes it more difficult for investors to take informed investment decisions.

Such shortcomings were highlighted by respondents to the 2011 Green Paper on EU Corporate Governance (IP/11/404) who were in favour of better quality explanations. In addition, even if several Member States have initiated discussions or issued guidelines on the quality of explanations, such initiatives have taken place only in some EU countries and have often focused on specific national contexts. In order to maintain the key role of codes of conduct in ensuring good corporate governance and their legitimacy, the Commission considers that action at EU level is needed.

The Recommendation was chosen in order to maintain the flexibility of the 'comply or explain' approach. It will not be legally binding. However it provides practical EU guidance, based on national best practices across the EU, for listed companies, investors and national monitoring bodies. In this way it should improve the quality of disclosures and ensure better transparency.

3. What are the main objectives of the Recommendation?

Its objectives are twofold:

- to provide guidance on how listed companies should explain their departures from the recommendations of the relevant corporate governance codes; and in addition
- to encourage European listed companies to report on how they followed the relevant corporate governance codes on the topics of most importance for shareholders, in order to improve transparency and quality of corporate governance reporting in general.

4. What's next?

The Commission invites Member States to inform it of the measures taken in accordance with this Recommendation by spring 2015. This would allow the Commission to assess whether any further measures are necessary.