THE SHAREHOLDER RIGHTS DIRECTIVE: AN ENGAGING OPPORTUNITY

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IN Q2 2019, THE LONG AWAITED SEQUEL TO THE SHAREHOLDER RIGHTS DIRECTIVE – ‘SRD II’ – IS COMING TO A COMPLIANCE DEPARTMENT NEAR YOU.

The amendment to the European Union (EU) Directive will empower investors by requiring greater transparency along the investment chain, an extended set of rights and the removal of barriers to the exercise of those rights. Along with this increased power comes increased responsibility and opportunity.

The investment industry, however, is ill-prepared for this change, and more concerning still is the limited discourse across member states on local transposition of the Directive into national law and its implementation. We believe the Directive, through encouraging more effective investor stewardship, provides an opportunity for positive change in corporate governance with benefits for many stakeholders, and should be embraced.

THE AMENDMENT

In May 2017 the European Parliament and Council agreed an amendment to the 2007 Directive (SRDI) that established fundamental shareholder rights across the EU. The amendment to be implemented by member states by 10 June 2019, seeks to:[1]

- **Contribute to the sustainability of EU companies** – by requiring investors to report on how the main elements of their investment strategy contributes to the medium to long-term performance of their clients' assets.
- **Enhance the efficiency of the chain of intermediaries** – by identifying shareholders,[2] improving the transmission of information along the investment chain, including on engagement, voting and manager reward, and alignment between investment strategy and client/beneficiary liability.
- **Encourage long-term shareholder engagement** – by requiring policies and reporting on engagement with investee companies regarding performance (on strategy, governance, and environmental and social issues), and providing investors with a vote on company remuneration policy and reports.

The Directive aims to enable more effective engagement between investors and companies while at the same time encouraging long-term thinking.

Engagement is perhaps the key tool for investor stewardship along with monitoring and voting. We believe the third objective above on encouraging engagement has the greatest potential for systemic change.

> The financial crisis had shown that many shortcomings in corporate governance of listed companies contributed to the financial crisis. For example, important deficiencies in the engagement and control by shareholders impede good decision-making by companies.

– European Commission, March 2017[1]

THE MARKET FAILURE

Few investors have taken on the responsibility to genuinely engage with companies. Some only deliver cursory or ineffective engagement that focuses on a single issue, centres on annual general meetings (AGMs) or only reaches as far as investor relations.

> There is clear evidence that the current level of 'monitoring' of investee companies and engagement by institutional investors and asset managers is often inadequate and focuses too much on short-term returns.

– 'SRD II' – EU Directive 2017/828, May 2017

By propelling the investment chain into action, the Directive seeks to address a market failure: prevalent short-termism in investing at the expense of long-term stewardship. Short-term shareholder actions and thinking have too often become embedded in the way companies are managed, to the detriment of a broader set of stakeholders and, sometimes, the investors' own clients.

The European Commission, the EU executive, identified this market failure and established the Directive as a major new vehicle to address it. While strategies and views on the purpose and method of stewardship vary across investors, the Directive strongly encourages both institutional investors[3] and asset managers to consider their stewardship opportunity and responsibility, whether undertaken themselves or via nominated intermediaries. Engagement can be defined as a mechanism available to financial stakeholders, ensuring appropriate accountability of boards and management of investee companies, and empowering them to make long-term decisions in the interests of sustainable wealth creation and, ultimately, all stakeholders. Critically, the Directive aims to enable more effective engagement between investors and companies while at the same time encouraging long-term thinking.

Investors, including some of the largest asset managers, are now building stewardship capability, recognising it can, when implemented effectively, improve returns, reduce downside risk and achieve additional outcomes in the broader interests of beneficiaries.[4] Ultimately, it can create greater long-term value for all stakeholders. These outcomes are borne out by independent research.[5]

[1] SRDII press release, http://europa.eu/rapid/press-release_MEMO-17-592_en.htm [2] Though the definition of 'shareholder' has variations across the Union. [3] The Directive uses the term institutional investor for what may otherwise be referred to as asset owners (being pension schemes and insurers defined in ART1(2)(b)(e) of the Directive) [4] Such as equality and environmental protection [5]See, for example, Hoepner A., Oikonomou I., Sautner, Z., Starks, L.T., and X. Zhou (2018): ESG Shareholder Engagement and Downside Risk. Working Paper; Dimson, E., Karakas, O., and X. Li (2015): Active Ownership. Review of Financial Studies, 28(12), 3225-3268; Barko, T., Cremers, M., and L. Renneboog (2017): Activism on Corporate Social Responsibility. ECGI Working Paper No 509/2017; Principles for Responsible Investment (2018): ESG Engagement for Fixed Income Investors – Managing Risks, Enhancing Returns; Principles for Responsible Investment (2018): How ESG Engagement Creates Value For Investors and Companies

> By under-delivering on stewardship, the investment industry is leaving beneficiary value on the table and missing the opportunity to have a positive impact on the environment and society.

– Dr Hans-Christoph Hirt, Hermes EOS

However, investors with adequate and demonstrably effective stewardship capability remain a small minority of the industry. The Directive requires institutional investors and asset managers to justify why they do not have or have not implemented an engagement policy; a step change for many pension funds and insurers in particular.

Through increasing transparency and awareness, the Directive should shed light on those investors who do not fulfil their responsibility as delegated stewards of financial stakes in a company and the assets of their clients and beneficiaries. For example, this could be investors who do not engage at all with investee companies or only around AGMs, or reactively following public pressure on a particular issue. Or, those who do not appropriately use voting as part of an engagement approach, but default to following the recommendations of management or research providers, without considering the wider stewardship implications: whether the proposal under consideration is truly in line with their mandate, their clients'/beneficiaries' objectives or the long-term benefit of the company itself.

To be impactful on engagement, we believe member state transposition must pay due regard to the spirit and purpose of the directive and emphasise how stewardship is conducted in practice.

ONE COMMON BASELINE

The form the Directive will take in each member state is slowly emerging, though the Directive sets clear requirements and offers limited flexibility. Provided member states respect its purpose the Directive, supported by the Implementing Acts, should drive towards common objectives, minimum standards and, ultimately, outcomes across member states.

To be impactful on engagement, we believe member state transposition must pay due regard to the spirit and purpose of the directive and emphasise how stewardship is conducted in practice – i.e. the Directive's requirements on reporting on implementation rather than the policy[6] itself. This is significant, as disclosure requirements under existing stewardship codes typically focus on the latter.

By focusing instead on the implementation of policy, reporting under the Directive is more likely to drive positive behaviour change and awareness along the investment chain, taking stewardship practice to the next level. However, the majority of the investment industry is currently ill-prepared to deliver reporting beyond policies and processes, to demonstrate the depth, breadth and effectiveness of their stewardship activities.

Hermes EOS has supported the introduction of stewardship codes and shareholder rights regulation for over 14 years.[7] From our experience, regular public reporting on engagement should include the following information:

Across all investee companies:

- Voting behaviour:
  - Meetings in favour, against and abstaining;
  - votes against management by issue;
  - support for shareholder resolutions;
  - rationale for the most significant vote decisions;
  - engagement around the votes;
  - variations relative to the retained proxy research provider; and
- Actual and potential conflicts of interest.

Across all companies engaged:

- The process for selection of companies for engagement;
- the number of companies engaged;
- seniority of company representatives engaged (IR, specialists, CEO/CFO and board level);
- issues addressed through engagement and time devoted to them;
- progress made against predefined engagement objectives; and
- resource that is dedicated to engagement (and, if separate, its interaction with fund managers).

On the most significant engagements:

- Objectives of engagement that are most material to the company or industry in which it operates and according to the geographic and cultural norms that are appropriate for its location;
- interaction type (E.g. meeting/call/statement at annual general meeting), seniority levels engaged and issues addressed;
- engagement and collaboration with other investors and stakeholders;
- under certain circumstances, how the engagement has been escalated;
- the outcomes and progress against objectives; and
- continuing monitoring of the company and its response.

[6] A policy is named 'engagement policy' under the Directive but 'stewardship policy' under some stewardship codes.
[7] https://www.hermes-investment.com/ukw/stewardship/eos-services/

RAISING STANDARDS

The Directive seeks to create a common set of minimum standards across the EU market, closing the existing gap between most member states and those few states with existing stewardship regulation and, in some cases, a tradition and culture of constructive engagement between investors and companies. Active engagement across the EU has at least in part been driven by the development and presence of stewardship codes in a number of markets.

> Our institute sees continuous improvement in shareholder engagement as in the public interest.

– The Institute of Chartered Secretaries and Administrators[8]

The Directive, however, will not replace existing codes but instead set a new market baseline for stewardship. Indeed, codes underpinned by legislation may be a vehicle for implementing the Directive in member states. However, the standard set by the Directive does not extend to the full set of monitoring and disclosure requirements of stewardship codes though it is a significant step up from current practice for the majority of the investment industry. Investors already operating in accordance with such codes are better placed for the increased expectation under the Directive. The codes will play an equally vital role in continuing to create a more ambitious and higher standard for those who wish, and are able, to go beyond the requirements of the Directive, and will thus contribute to a higher level of stewardship. However, as codes drive a higher level of stewardship, signatories may decrease after implementation of the Directive, as the transparency it requires will shed greater light on, and highlight, different levels of performance.

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FULFILLING ITS POTENTIAL

The Directive will only be successful if the wider investment ecosystem is aligned with its objectives and active in its adoption. There remains significant implementation risk through weak transposition, in particular a lack of enforcement and effective consequences for poor disclosure, poor compliance or poor explanations of non-compliance which are vital if ‘comply or explain’ approaches are to change behaviour.

However, we believe that member states will see the economic and social benefits of active stewardship and engage with the Directive. It is in the interests of any member state wishing to drive sustainable wealth creation to transpose robust measures into national law.

From our experience support from local institutional investors will be key in making stewardship regulation work.

From our experience, in addition to national authorities and supervisory bodies, support from local institutional investors, particular the larger players in the market, will be key in making stewardship regulation work. They will need to become early adopters, invest resources and challenge fund managers, thus providing an enforcement mechanism, and provide market leading disclosure. Also, support from international investors will further drive the objectives and change sought by the Directive.

INTENDED CONSEQUENCES

The boost the Directive will bring to transparency and awareness of investor stewardship across the investment industry, and broader stakeholders, will not come without wider systemic impact.

Competition among asset managers will be a friend to the Directive. Long-term focused strategies, positive change through effective engagement and reporting outcomes are all areas in which managers can compete, and a way for the industry to demonstrate value for money in light of recent scrutiny.[9] Reporting on stewardship performance could be a mechanism by which investors will make informed value-for-money decisions on the asset manager options in the market.

Pension funds and insurers are already becoming more aware of what can be achieved through long-term thinking and engagement. Their informed decision-making on mandate allocation will help drive healthy competition, and contribute to addressing the current market failure in stewardship. This will be further enhanced as the Directive boosts transparency and awareness on whether asset manager reward is driving the right behaviours and outcomes.

[8] ICSA: Shareholder engagement: the state of play (July 2018)
[9] Increased disclosure requirements, for example under MiFID II, have sought, in part, to shed light on value for money.

> Greater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors.

– 'SRD II' – EU Directive 2017/828, May 2017

A further significant impact of the Directive may be the subsequent regulation it enables. By motivating and supporting shareholder stewardship, the Directive is a key building block for future sustainable finance regulation, such as greater transparency by investors on the integration of sustainability risks. Ultimately its greatest impact should be the long-term sustainability of EU companies and economies.

If the Directive fails to engage investors in their responsibilities – either through weak transposition or a lack of an effective response from the investment industry – the European Commission may become more stringent in its approach.[10] The industry should embrace the Directive and take the lead. It has, along with its clients and ultimate beneficiaries, much to gain by doing so.

TIME TO ACT

The Directive will create opportunity for investors who wish to engage with its objectives, for the benefit of both investee companies and their clients and beneficiaries, as well as the economy and society as a whole.

The Directive should drive substantial change in the investment industry. Who knows, it may even reduce short-termism.

[10] This could for example take the form of a levy on the industry to resource effective engagement or an 'apply and explain' rather than 'comply or explain' approach.

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HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Multi asset
Multi asset inflation

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices
London | New York | Singapore

Why Hermes EOS?
Hermes EOS enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. Hermes EOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

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