

EU Shareholder Rights Directive: Action required for Switzerland?

 www.capl原因.ch/2016/eu-shareholder-rights-directive-action-required-for-switzerland/

Thomas U. Reutter

Efforts to amend the EU Shareholder Rights Directive have lost momentum. The most recent resolution of an EU institution has been passed more than a year ago by the EU parliament. The Brexit vote in the United Kingdom has cast further doubt on the directive's future design. Nevertheless, efforts to improve the governance of European companies and to strengthen the rights of shareholders will continue and the most recent proposal to amend the directive is likely still indicative of the future form and shape of corporate governance in the EU. Third countries like Switzerland should closely monitor the EU's next steps on the directive, analyze any gaps and decide whether such gaps should be closed.

By Thomas U. Reutter (*Reference: CapLaw-2016-43*)

1) Introduction and Status of Legislation

The Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies has been adopted in 2007 (publication in the Official Journal on 11 July 2007; hereafter **SRD**). The SRD aims to ensure a certain minimum level of shareholder participation rights and good corporate governance within the EU.

On 9 April 2014 the EU Commission published a proposal to amend the SRD “as regards the encouragement of long-term shareholder engagement” together with an “Impact Assessment” based on consultations and research undertaken. In such assessment, the EU Commission noted the following deficiencies in the corporate governance framework:

1. Insufficient engagement of institutional investors and asset managers in the governance of listed companies;
2. Insufficient link between pay and performance of directors (including executive management);
3. Lack of shareholder oversight on related party transactions;
4. Doubts on the reliability of the advice of proxy advisers;
5. Obstacles to the exercise of shareholder rights (in particular due to the use of intermediaries in cross border situations); and
6. Insufficient quality of corporate governance information.

On 8 July 2015, the EU parliament has adopted a resolution changing the draft amendments presented to it by the Committee on Legal Affairs (JURI Committee), based on the proposal put forward by the Commission on the above perceived governance shortcomings in listed companies (hereafter the **Proposed SRD Amendment**). No further step in legislation has been publicly announced since then. It is likely that the uncertainties surrounding the exit of the United Kingdom (UK) out of the EU have delayed the project. Many of the companies and most of the institutional investors and asset managers addressed by the Proposed SRD Amendment are domiciled in the UK and the legislation would certainly be less effective if not transposed into UK national law. Nevertheless, efforts to improve the governance of European companies and to strengthen the rights of shareholders will continue also without the UK as an EU member.

2) Companies in Scope

As its name indicates, the SRD only addresses the rights of shareholders in companies which have (1) their

registered office in a member state of the EU and (2) whose shares are admitted to trading on a regulated market in any such member state (article 1 SRD). In case the country of incorporation or registered office and the country of the trading venue differ within the EU, the country of incorporation is competent to regulate the matters of the SRD. Compare this to the recently enacted Swiss “Minder” legislation (Ordinance against excessive compensation in listed companies; **OaeC**), which bolstered the role of shareholders in corporate governance and in particular in say-on-pay issues. Both legislations are applicable to listed companies only. Moreover, both legislations opt for the registered office (country of incorporation) rather than the country of the listing (trading venue) as the competent country to legislate. However, the EU legislation does not capture any issuer who, although incorporated in any EU member state, is listed outside of the EU. The OaeC, by contrast, is applicable to any Swiss issuer whose shares are listed on a stock exchange anywhere in the world, which may create conflicts with any corporate governance requirements in the country of the listing.

3) Focus on Shareholder Engagement and Related Party Rules

This article focuses on the interaction of listed companies with their shareholders and in particular with shareholders who are institutional investors or asset managers (items 1 and 5 of the above list) and on related party transactions (item 3 above). These appear to be the most relevant from a Swiss perspective for the following reasons: The problem identified as insufficient link between pay and performance (item 2 above) of directors has been addressed under Swiss law with the enactment of the OaeC, which goes beyond the requirements of the Proposed SRD Amendment and requires, *inter alia*, an annual binding vote on the remuneration payable to the board of directors and the executive management. If at all, the EU will consider the say-on-pay lessons learnt in Switzerland in the forthcoming debate on the SRD rather than the opposite. Although regulation of proxy advisers (item 4 above) is debated topic in Switzerland as well, the substance of the Proposed SRD Amendment is unlikely to have an impact in third countries. It leaves the required code of conduct essentially to the self-regulation of the industry and only imposes certain limited disclosure obligations regarding compliance with the chosen code of conduct. Apart from that, the most relevant proxy advisers for Swiss companies are domiciled outside Switzerland and are difficult to regulate by one single country apart from the US.

4) Shareholder Engagement

In its Impact Assessment, the Commission noted that shareholders had remained too passive in the past and, by behaving in this manner, have insufficiently controlled the board of directors and the managements as their agents. As a result, corporates have allegedly taken excessive risks and management remuneration has been decoupled from company performance. However, both the Commission and the Parliament seem to realize the inherent boundaries of forcing investors to more engagement and have shied away from imposing an obligation to vote. Switzerland, by contrast, has introduced such an obligation, albeit limited to certain Swiss pension funds. The Proposed SRD Amendment is less strict. It either requires institutional investors and asset managers to adopt a so called “Engagement Policy” or give a clear and reasoned explanation as to why no such policy has been adopted (“comply or explain”). In such Engagement Policy, investors would have to describe, *inter alia*, how they integrate shareholder engagement in their investment strategy, how they intend to vote in general and to what extent they intend to retain the services of proxy advisers. The Engagement Policy must also include detailed conflict of interest rules. Once a year, institutional investors and asset managers must publish a document on their website detailing how they have implemented such policy. Pursuant to the principle of “comply or explain”, investors may also refrain from such annual publication if they give a reasoned explanation as to why this is the case.

5) Far Reaching Obligations for Institutional Investors

More importantly, pursuant to the Proposed SRD Amendment, institutional investors and asset managers must publicly disclose on their website, for each company in which they hold shares, whether and how they cast their votes in general meetings and provide an explanation for their voting behavior. The “comply or explain” principle does not seem to apply to this far-reaching obligation. It remains to be seen, whether such obligation will be included in the final version of the Proposed SRD Amendment. It is definitely stricter than the corresponding Swiss

requirement, which provides for a general obligation for Swiss pension funds to disclose a summary of their voting behavior to their beneficiaries. The Swiss version is more limited in that no public disclosure is required and, except in specific cases, a generic summary will be sufficient.

A far reaching obligation is imposed on institutional investors. Not only must they publicly disclose their investment strategy and how it is aligned with the profile and duration of their liabilities, but also the main arrangements, if any, with any asset manager. The disclosure regarding arrangements with asset managers includes the incentives awarded to the asset managers and their impact on the investment strategy of the institutional investor. This would impose far reaching transparency obligations in arrangements that would otherwise be purely private. The questions may be asked whether risk taking conduct or abuses that happened in the past have been egregious enough to justify a public interest in the disclosure of private transactions as proposed and if so, whether such behavior could be avoided by the proposed disclosure. In any event, Swiss law would significantly deviate from the law of EU member states if the Proposed SRD Amendment would be transposed into national law in its current form.

6) Communication with Shareholders

Shareholder engagement necessitates communication between the issuer and its shareholders. The Proposed SRD Amendment intends to remove obstacles for such a dialogue by allowing listed companies to identify their shareholders. Intermediaries like custodian banks or central security depositories (**CSD**) should be responsible to provide the necessary information about shareholder's identity to the listed companies. Although the Proposed SRD Amendment expressly states that the right to identify shareholders is conferred "taking into account existing national systems", it is unlikely that the current Swiss system for registered shares would comply with the Proposed SRD Amendment. Owners of registered shares of Swiss listed companies are under no obligation to notify the share register and disclose their identity to the company. Although dividends and other financial rights are granted for these shares, they cannot be voted at shareholder meetings (these "unregistered" registered shares are known as so called "Dispo-shares"). The shareholder's custodian bank obviously knows the identity of its client but is not allowed to disclose such information to the company absent consent of the shareholder. A proposed amendment to Swiss corporate law aims to improve the current situation around Dispo-Shares by introducing a so called nominee model in which the custodian bank would be registered as holder of record in lieu of the actual "true" shareholder (See Commentary to an amendment of the Swiss Code of Obligations dated 28 November 2014 item 1.3.3 (*Erläuternder Bericht zur Änderung des Obligationenrechts*)). While this model has certain benefits, it does not involve disclosure of the identity of the beneficial owner of the shares "behind" the nominee to the listed company. If the current regulation in the Proposed SRD Amendment becomes final, Swiss corporate law would therefore significantly deviate from EU legislation.

7) Related Party Rules

As mentioned earlier, the Impact Assessment of the Commission has analyzed shortcomings also in the area of related party transactions. In addition to the ex post disclosure of related party transactions required by applicable accounting standards (in particular IFRS) the Proposed SRD Amendment introduces an ad hoc disclosure requirement for material related party transactions. As a result, companies would have to publicly disclose material transactions with related parties, including the name of the related party, the value of and nature of the transaction, "at the latest at the time of conclusion of the transaction". The announcement must be accompanied by a report "assessing whether or not [the transaction] is on market terms and confirming that [it] is reasonable from the perspective of the company, including minority shareholders...".

The term "related party" has the same meaning as under IFRS (see IAS 24). It includes transactions by the listed company with a board member or any shareholder. The materiality of such a transaction will be left to member states to define subject to some general guidelines set out in the Proposed SRD Amendment. Member states may also exclude transactions entered into in the ordinary course of business and concluded on "normal market terms".

The Proposed SRD Amendment, in its current form, does not require an affirmative vote by shareholders for

material related party transactions. The “administrative or supervisory body” of company may as well approve related party transactions provided that procedures are in place that prevent a related party from taking advantage of its position. However, member states may introduce a requirement that material related party transactions will have to be approved by shareholders, in which case the conflicted (related party) shareholder may also vote, provided that the interests of non-related party shareholders are sufficiently protected. The Proposed SRD Amendment has softened significantly the original proposal by the EU Commission and the consent and abstention requirements currently foreseen are not particularly onerous and do not go beyond good corporate practice.

From a Swiss perspective, the main gap to the Proposed SRD Amendment regarding related party transactions is therefore the new ad hoc requirement for material related party transactions and the corresponding report that would have to be established.

8) Conclusion

Efforts to improve the governance of European companies and to strengthen the rights of shareholders will continue after the Brexit vote if the UK and the most recent proposal to amend the Shareholder Rights Directive is likely still indicative of what corporate governance in the EU will look like in the future. Third countries such as Switzerland should closely monitor the EU’s next steps on the directive. This article has shown that significant gaps remain between Swiss law and the most recent EU proposal, which includes far reaching obligations on disclosure of shareholder identity, transparency obligations of institutional investors and related party transactions. If these proposals find their way into the final directive, Switzerland will have to carefully consider whether it is itself poised for fundamental changes to certain concepts it has grown accustomed to in the past decades.

Thomas U. Reutter (thomas.reutter@baerkarrer.ch)