

# PRI POLICY BRIEFING

## EU SHAREHOLDER RIGHTS DIRECTIVE (2016)

The revised Shareholder Rights Directive (2007/36/EC) recognises that shareholders often exert short-term pressure on investee companies, at the expense of longer term value creation and ESG issues. The Directive seeks to mitigate this by addressing some principal agent problems in the investment chain.

### AT A GLANCE

<b>Institutional Investors<sup>1</sup></b>	<p>Establish and publicly disclose an engagement and voting policy. Publicly disclose how they implement the policy on an annual basis.</p> <p>Publicly disclose how their equity strategies align with the profile and duration of their liabilities, particularly long-term liabilities, and how they incentivise and monitor asset managers to do the same.</p>
<b>Asset managers</b>	<p>Establish and publicly disclose an engagement and voting policy. Publicly disclose how they implement the policy on an annual basis.</p> <p>Disclose to institutional investor clients how their equity strategy aligns with long-term liabilities.</p>
<b>Proxy advisors</b>	<p>Publicly disclose compliance with a code of conduct, to be determined by the Member State.</p> <p>Publicly disclose key elements of how they prepare research, advice and voting recommendations</p>
<b>Company Directors</b>	<p>Establish a clear remuneration policy in line with the long-term interests and sustainability of the company. Submit the policy to vote at least every four years. Member states may make this vote binding or advisory.</p> <p>Provide a clear, understandable remuneration report, including explaining how remuneration contributed to the long-term performance of the company. The report is subject to an advisory vote at the annual meeting.</p>

In general, institutional investor, asset manager and proxy advisor requirements are on a comply-or-explain basis. Requirements for company directors are mandatory<sup>2</sup>.

<sup>1</sup> Defined as Institutions for Occupational Retirement Provision (IORPs) and those providing life assurance.

<sup>2</sup> Member States can allow temporary deviation where necessary for the long-term interests or sustainability of the company.

## DEVELOPMENT AND TIMELINE

A revised Shareholder Rights Directive was originally proposed in 2014. In December 2016, the European Parliament and Council reached political agreement on revision of the Shareholder Rights Directive with the intent of encouraging greater long-term shareholder engagement with companies. Following parliament scrutiny and approval, Member States have two years to transpose the Directive into national law.

The agreed text can be viewed at: <http://data.consilium.europa.eu/doc/document/ST-15248-2016-INIT/en/pdf>

## KEY ESG ARTICLES

This briefing identifies the key responsible investment-related articles in the Directive:

- Recital
- Article 3a: Identification of shareholders
- Article 3f: Engagement policy
- Article 3g: Investment strategy of institutional investors and arrangements with asset managers
- Article 3h: Transparency of asset managers.
- Article 3l: Transparency of Proxy Advisors
- Article 9a: Right to vote on the remuneration policy
- Article 9b Information to be provided in the remuneration report and right to vote on the remuneration report

## PRI POSITION

### Institutional investor and asset manager requirements

The PRI strongly supports active, engaged ownership of companies over the long-term. This is strongly in line with the six Principles, especially Principle 2: *We will be active owners and incorporate ESG issues into our ownership policies and practices.*

By placing a positive duty on all investors to consider stewardship and long-term factors, the Directive will address many of the weaknesses identified by PRI's [Global Guide to Responsible Investment Regulation](#). The PRI has previously demonstrated that the [majority of European PRI signatories](#) already comply with, or exceed, the disclosure requirements of the Directive.

### Resources

- The PRI's [ESG Engagements team](#) has a series of resources, including:
  - guidance for investors engaging companies on issues such as tax transparency, anticorruption, director nominations, ESG and remuneration, water risks, methane emissions, hydraulic fracturing, human rights, labour standards in the supply chain and employee relations
  - an [introductory guide to collaborative engagement](#)

- a private [collaboration portal](#) with details of current ongoing collaborative investor engagements.
- All PRI investor signatories must disclose details of their ESG integration and active ownership activities annually. For examples of engagement and voting policies, see [Transparency Reports](#), module “Listed Equity: Active Ownership”.

### Say on pay

The PRI welcomes the required vote on remuneration policy and remuneration report.

A regular vote on remuneration policy gives shareholders greater opportunity to encourage alignment with long-term strategy and value creation. Some PRI signatories report that ‘say on pay’ rules have encouraged deeper dialogue between investors and company boards<sup>3</sup>. We do not take a view on whether such votes should be binding or advisory; the PRI’s work and the academic literature has yet to demonstrate that binding votes on remuneration policy significantly impact how companies determine pay<sup>4</sup>, or the active ownership practices of shareholders.

The PRI welcomes disclosure, in the remuneration report, on the relative components of fixed and variable remuneration, the alignment between remuneration and long-term value creation, and relative change in remuneration over the past 5 years. We would encourage member states to also require enhanced transparency around the role of the remuneration committee and/or any independent expertise engaged to determine pay.

### Resources

- Integrating ESG issues into executive pay: guidance for investors and companies (forthcoming in early 2017, available at: <https://www.unpri.org/about/pri-teams/esg-engagements>)
- [Integrating ESG issues into executive pay: a review of global utility and extractive companies](#) makes additional recommendations for the utility and extractive sectors.

## CONTACT DETAILS

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<sup>3</sup> This has also been supported by some industry studies, for example: ISS (2013), [Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives](#)

<sup>4</sup> For example, <https://corpgov.law.harvard.edu/2015/04/03/a-say-on-say-on-pay-assessing-impact-after-four-years/>, <http://homepages.ed.ac.uk/mainbg/Files/Binding%20votes%20on%20executive%20remuneration.pdf>

## DETAIL OF ESG CLAUSES

### RECITAL

The recital outlines the objectives and key requirements of the Directive. Article 8 references the Principles for Responsible Investment as a framework for understanding financial and non-financial/ESG issues<sup>5</sup>.

### ARTICLE 3A: IDENTIFICATION OF SHAREHOLDERS

Companies have the right to request identification of shareholders. This information must be communicated without delay, including between intermediaries. Member states can restrict this to only shareholders holding more than 0.5% of shares or voting rights.

### ARTICLE 3F: ENGAGEMENT POLICY

Institutional investors and asset managers must comply with the following requirements or provide a clear, reasoned explanation as to why not:

- Develop and publicly disclose an engagement policy that describes how engagement is integrated into the investment strategy. This should explain how they:
  - monitor investee companies including on strategy, financial and non-financial performance and risk, social and environmental impact and corporate governance
  - conduct dialogue with investee companies
  - exercise voting rights
  - cooperate with other shareholders
  - communicate with other relevant stakeholders of the company.
- Disclose on an annual basis how the policy was implemented, including:
  - a general description of voting behaviour
  - an explanation of the most significant votes
  - how proxy advisors are used
  - how votes were cast, with the right to exclude votes deemed insignificant due to subject matter or size of holding. Where an institutional investor delegates engagement and voting, they may refer to the asset manager's voting disclosures.

Disclosures must be publicly available via the investor's website. Where voting is outsourced to an asset manager, institutional investors may refer to the asset manager's website.

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<sup>5</sup> The PRI prefers the terminology "ESG" to avoid the impression that such issues are not financially material.

## ARTICLE 3G: INVESTMENT STRATEGY OF INSTITUTIONAL INVESTORS AND ARRANGEMENTS WITH ASSET MANAGERS

- Institutional investors should disclose how the main elements of their equity strategy;
  - are consistent with the profile and duration of their liabilities, in particular long-term liabilities, and;
  - how they contribute to the medium to long-term performance of their assets.
- Where an institutional investor outsources to an asset manager, the institutional investor must disclose:
  - how the arrangement with the asset manager incentivises them to align their investment strategy and decision-making with the profile and duration of the liabilities of the institutional investor, in particular long-term liabilities, in order to improve medium to long-term performance;
  - how performance evaluation and remuneration of the asset manager takes long term performance into account;
  - if, and how, portfolio turnover costs are monitored;
  - The duration of the arrangement with the asset manager.
- Institutional investors should disclose how they incentivise and monitor asset managers to align investment strategy and decisions with these long-term liabilities.

The investor should give a clear and reasoned explanation if the arrangement does not include one or more of these elements. All disclosures in Article 3G must be available for free on the investor's website.

## ARTICLE 3H: TRANSPARENCY OF ASSET MANAGERS

Asset managers must disclose to the institutional investor, free of charge, twice per year, how their investment strategy and implementation complies with that arrangement and contributes to medium to long-term performance of the institutional investor. This includes:

- how their strategy and implementation complies with the arrangement and contributes to medium to long-term performance of assets
- if and how they base decisions on long-term and non-financial performance analysis
- key long-term risks
- portfolio composition and turnover characteristics.

## ARTICLE 3I: TRANSPARENCY OF PROXY ADVISORS

- Member states must ensure that proxy advisors apply and report on a code of conduct, or provide a clear and reasoned explanation as to why not.
- Member states must ensure that proxy advisors publicly disclose, on an annual basis, details of how they prepare research, advice and voting recommendations including:
  - essential features of methodologies and models
  - main information sources

- quality control procedures, qualifications
- how national market, legal, regulatory and company-specific conditions are taken into account
- essential features of voting policies for each market
- whether they have dialogue with companies, and the extent of this dialogue
- a conflict of interest policy.

All disclosures listed above must be publicly available on the proxy advisor's website. In addition, member states should ensure that proxy advisors disclose actual or potential conflicts of interest to their client without delay.

## **ARTICLE 9A: RIGHT TO VOTE ON THE REMUNERATION POLICY**

- Member states must ensure that shareholders have the right to vote on a directors' remuneration policy at least every four years. Member states can decide if this vote is advisory or binding.
  - Where the vote is binding, companies may only pay directors in accordance with an approved remuneration policy. Where a remuneration policy is rejected, the company will continue to pay in line with any previously approved policy<sup>6</sup> and re-submit a revised version of the new policy for approval at the next general meeting.
  - Where the vote is advisory, companies can only pay remuneration in line with a policy which has been submitted to a vote. If the policy is rejected, the company must submit a revised policy at the next general meeting.
- Member states can exempt companies in exceptional circumstances necessary for the long-term interests and sustainability of the company.
- The remuneration policy will contribute to the business strategy, long-term interests and sustainability of the company and explain how it does so. It will describe the relative proportion of the different components of fixed and variable remuneration and all other benefits awarded to directors. It will explain how the pay and employment conditions of employees of the company were taken into account when setting the policy, and how the policy contributes to the business strategy, long-term interests and sustainability of the company.
- The policy must set clear, comprehensive criteria for how variable remuneration is awarded, including, where appropriate, criteria relating to corporate social responsibility.

## **ARTICLE 9B: INFORMATION TO BE PROVIDED IN THE REMUNERATION REPORT AND RIGHT TO VOTE ON THE REMUNERATION REPORT**

- Companies must create a clear, comprehensive and understandable remuneration report detailing how directors were compensated in the past year. This includes:

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<sup>6</sup> Where no policy has yet been approved, the company can pay in line with 'existing practices'.

- the total remuneration split by fixed and variable components, and how the total remuneration is aligned with long-term performance of the company
- annual change in remuneration over at least the last five years, alongside the evolution of the company's performance and the average remuneration of non-director employees.
- The remuneration report will be subject to an advisory vote at the annual meeting. If the advisory vote rejects the report, the company must explain how this was taken into account in the next remuneration report.