CORPORATE GOVERNANCE POLICY IN THE EUROPEAN UNION

Through an Investor's Lens

CFA Institute

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AUTHORS

George Dallas
Policy Director
International Corporate Governance Network

David Pitt-Watson
Executive Fellow
London Business School

CONTRIBUTORS

Kurt N. Schacht, JD, CFA
Managing Director
Standards and Advocacy
CFA Institute

Rhodri G. Preece, CFA
Head
Capital Markets Policy, EMEA
CFA Institute

Josina Kamerling
Head
Regulatory Outreach, EMEA
CFA Institute

We would like to extend our sincere thanks to the individuals who participated in the CFA Institute corporate governance workshops that served as the basis for this report. These participants and their affiliations are listed in Section D of the Appendix.

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Foreword

CFA Institute commissioned this project to examine the state of corporate governance policy and practices in Europe and to articulate a constructive investor's perspective on the development of governance policy and practice.

Against this backdrop, CFA Institute engaged with 30 investment practitioners from primarily institutional investors as well as other stakeholders to consider the state of European corporate governance and to set forth a vision for the governance agenda going forward. These professionals come from across Europe, and their institutions are investors in some of Europe's largest companies.

As owners of European companies, often on behalf of insurers and pension funds, institutional investors are key stakeholders in the governance ecosystem. They play a central role in the implementation of governance standards, and it is appropriate that they should help shape the direction of future policy initiatives.

To facilitate this project, CFA Institute engaged with two seasoned investors and luminaries in the field of corporate governance: George Dallas, policy director at the International Corporate Governance Network, and David Pitt-Watson, executive fellow at the London Business School. David and George facilitated three investor workshops that were held in London and Brussels in early 2016. These workshops inspired a series of rich and productive discussions, the synthesis of which forms the foundation of this report. We extend our sincere thanks to David, George, and all of the workshop participants, whose names and affiliations are listed in Section D of the Appendix.

The report concludes with a series of action memoranda directed to the various stakeholders in the corporate governance agenda. We hope these memoranda serve as the basis for further dialogue that will strengthen corporate governance standards and practices and thereby enhance the integrity of European capital markets.

Kurt N. Schacht

Kurt N. Schacht, JD, CFA
Managing Director, Standards and Advocacy
CFA Institute

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Executive Summary

European corporate governance reform is at a crossroads. For the past 15 years, the European Union (EU) has, with some success, been pursuing a policy of strengthening company boards, increasing information flows, and encouraging institutional investor oversight. However, following the completion of the revised Shareholder Rights Directive (SRD II), which is characterised by a series of arguably "disparate" initiatives,[1] the future governance agenda in Europe lacks clarity.

In this report, CFA Institute aims to help define a practical future vision for European corporate governance. Our findings are developed on the basis of interviews with leading European institutions and three half-day workshops with 30 investors and governance professionals who have responsibility for governance oversight. These professionals were drawn from Europe's leading institutional investment firms, with geographic representation from a range of European countries.

The workshops identified that investors believe there is still much that could be done in Europe to simplify mechanisms to enhance corporate accountability and realise maximum value from reforms that have already been undertaken. The findings note that investors are open to many stakeholder issues, such as promoting board diversity, environmental reporting, or good corporate citizenship more generally. Importantly, however, the findings also highlight investors' concerns that there is still inadequate protection against abuse by controlling shareholders as well as a continued opportunity to further enhance board accountability to minority shareholders.

Workshop participants felt that governance systems need to be flexible and that the flexibility might best be achieved by comply-or-explain mechanisms along with some limited hard laws to ensure accountability. They also noted that currently, the investment industry falls short in carrying out its full stewardship responsibilities and that those in the industry as well as other participants in the governance ecosystem need to be reminded and encouraged to carry out their proper roles and responsibilities.

For the future, the report findings suggest that pressures influencing governance policies will reflect differing views of capital markets and corporate purpose. Champions of a shareholder-focussed governance system may be at odds with advocates of a stakeholder-focussed system, or an "open market" system, in which governance requirements

[1]See Hopt (2015) for more information.

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may be *laissez faire* and more subject to market forces than standard setters. These competing propositions with a shareholder primacy model will not go away and will continue to exert an influence on the policy process. A distinctive feature of this report is the examination of policy options through these different lenses.

Investors will need to understand these differing perspectives and how to adapt to them. While promoting their own rights and responsibilities, shareholders must recognise stakeholder needs as well as the broader economic need for capital markets to stimulate sustainable economic growth and development.

However, there is a considerable opportunity to aspire to a "sweet spot" in which shareholder, stakeholder, and open market perspectives can be reconciled—as a type of trialectic synthesis. Our discussions identified a number of opportunities for progress and at least a general aspiration that the shareholder, stakeholder, and open market perspectives can fit together in relative harmony. Many stakeholder interests can be accommodated without diluting investors' rights or interests. Indeed, stakeholder considerations can strengthen long-term value creation. This approach suggests a common understanding of roles and responsibilities can be found, which can have lasting positive effects for both shareholders and stakeholders.

This vision is one that European policymakers and investors alike should seek to explore in their future policy agenda. With a renewal of the investor vision for European corporate governance and with proper attention to the governance "ecosystem," there is a considerable prize to be won in the growth, productivity, social, and environmental responsibility of European public companies. But it is unclear whether we are currently on a course to realise these benefits.

We conclude this report with action memoranda directed to the different policymakers and market participants involved in framing and implementing good governance. Better corporate governance, similar to better political governance, cannot be achieved by regulation alone. It also depends on an understanding among participants of their appropriate roles, rights, and responsibilities. Properly framed, we believe that there is considerable room for the development of better governance in the EU.

The action memoranda speak for themselves, but the following provides a summary.

Policymakers

1. Policymakers should be clear about what they want to achieve from corporate governance. We trust that the goals will be compatible with the investor vision outlined in Section VI of this report.

2. Policymakers should consider developing a guidance statement for company boards and for institutional investors that articulates stewardship expectations stemming from SRD II. This guidance should reflect sensitivity to the complexities of large asset managers that deal with widely diversified holdings, multiple mandates, and differing investment strategies. It might also establish the expectation that companies have a role to play in engaging with investors to achieve the broader goals of investor stewardship.

3. The European Commission should encourage strong monitoring mechanisms in individual European member states to ensure that companies and investors either adhere to governance and stewardship code requirements or provide a credible explanation. Different monitoring systems exist in some European markets, and the Commission should at least seek to ensure that individual member states have an appropriate mechanism to give substance to soft law.

4. The Commission should consider how further governance policy work might integrate with the Capital Markets Union (CMU). Governance is exercised through the capital markets. In this context, we emphasise the importance of ensuring coherence and joined up thinking between the governance mandates of DG JUST (Directorate-General for Justice and Consumers) and DG FISMA (Directorate-General for Financial Stability, Financial Services, and Capital Markets Union).

5. One of the most pressing practical concerns of investors is the protection of minority shareholder rights, particularly in the context of controlled companies. Measures needed to uphold minority investor protections include the following:

    a. Promoting better board accountability to minority shareholders, perhaps through more robust independence standards, a greater role in "hiring and firing" the board members, and stronger board diversity

    b. Continuing to press for rights relating to material related-party transaction votes (for example, as initially proposed under SRD II)

    c. Not promoting differential ownership rights and dual class share structures, which undermine open accountability

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6. Regulators should continue to work with market participants to fix the "plumbing" of cross-border proxy voting to ensure that shareholders are able to vote in an informed way and that all legitimately owned and cast votes by shareholders are formally counted and ultimately confirmable to the voting shareholder.

Investors

7. This policy direction places responsibilities on institutional shareholders to behave as fiduciaries. Institutional investors should regularly review their own internal governance standards. They should ensure appropriate tone from top management and clear expectations with regard to stewardship responsibilities.

8. Investors should be explicit in the need for corporate management to take a long-term view, and although financial considerations are likely to be at the fore, investors also should consider incorporating environmental, social, and other governance issues into risk analysis and the investment process. In this context, investors should accept the legitimate interests of stakeholders and note the considerable overlap between those interests and their own fiduciary duty to deliver value for their beneficiaries.

9. Investors should report to clients on how they discharge their fiduciary responsibilities. They should also report publicly on their compliance (or otherwise) with applicable stewardship codes and standards.

Companies

10. Companies should accept the need for accountability and either comply with an established corporate governance code or provide a thoughtful and legitimate explanation for code deviation. Companies should enable better monitoring of governance compliance.

11. We encourage companies to build a constructive attitude towards engagement with investors to establish mutual understanding and long-term relationships.

Part One

I. Introduction/Project Overview

Over the past 15 years, corporate governance has been an ongoing focus of European Union (EU) public policy and regulatory initiatives.

The logic for such intervention is clear. If Europe is to have a single capital market, it should be accompanied by an equivalent, if not identical, structure of company law among member states, including the role of boards, public disclosure standards, the rights of shareholders, and shareholder responsibilities. At the same time, because many consider that companies also have social obligations, there has been a desire to have these obligations reflected in the way that European companies are governed, particularly those companies that offer themselves for public investment. This is particularly true in the case of the banking sector given the systemic risks posed to society at large.

This wide range of governance-related issues creates a broad canvas for possible intervention by the EU, from boardroom diversity to minority shareholder rights. It also has a direct impact on investment professionals who not only depend on good governance for the integrity of the investments they manage but are also charged with corporate governance oversight of portfolio companies.

In commissioning this project, CFA Institute is exploring corporate governance policy in the EU through many perspectives. But the fundamental focus of this study is to review corporate governance in Europe through the lens of institutional investors, which play an intermediary and fiduciary role in making corporate governance systems work in the principles-based comply-or-explain governance frameworks across the EU.

This project began with a review of European legal and regulatory developments relating to corporate governance since the turn of the millennium up to the current day, which includes such current initiatives as the revisions to the Shareholder Rights Directive (SRD II) and the Capital Markets Union (CMU) as well as a recent communication on long-term financing. Following this historical review, meetings were held with the European Commission, European Parliament, OECD, European Securities and Markets Authority (ESMA), and the European Corporate Governance Institute to gauge the various political and economic perspectives on corporate governance.

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These meetings set the stage for a capstone set of three workshops conducted in early 2016 that involved a group of 30 participants, mainly representing institutional investors—including asset owners, asset managers, related trade bodies, and service providers—active in European investment markets and in promoting good corporate governance. The aim of our workshops was to understand what level corporate governance thinking has reached within EU investment institutions and to identify what investment professionals investing in European companies think may still be needed on the policy front. In particular, we asked workshop participants whether the EU corporate governance agenda

a. addresses the most important issues,

b. is proportionate in its approach, and

c. is practical in the rights and duties it assumes of investors.

Critically, we also sought to assess the views of institutional investors about how the future EU governance agenda can be framed in a way that allows it to work well, not only for investors but also for other interested parties. We presented options in the context of three models of governance that we define as shareholder focussed, stakeholder focussed, and open markets and sought to establish how these models may affect EU governance policy considerations in the future.

We hope that our findings will prove informative and helpful both to investors and to regulators in building an effective and practical consensus on corporate governance in the European Union.

II. European Corporate Governance History and Current Initiatives

In this section, we touch on the history of EU intervention in corporate governance and seek to identify the current key initiatives. (A more detailed chronology of EU interventions is listed in Sections A, B, and C of the Appendix.)

Since 2000, the actions of the EU have, in general, focussed on creating a system in which effective and accountable companies report to responsible shareholders. It has, therefore, tended to promote shareholder rights and responsibilities. The process has been slow and predictable, as befits a European corporate landscape that is heterogeneous legally and politically, that includes different philosophical approaches to governance, and that has markedly different ownership structures. Rather than establish a uniform code or set of rules for corporate governance, the EU has adopted a principles-based comply-or-explain regime for member state–based corporate governance codes.

The EU approach is consistent with the evidence that shareholder intervention improves economic performance.[2] But once SRD II is passed, we appear to be at the end of a cycle, and there is a danger that the approach of the past 15 years may dissipate.

Although corporate law and codes of governance come under the purview of individual member states, since 2000, there has been a steady stream of policy initiatives at the EU level aimed at improving standards of corporate governance along with the goal of promoting the larger macro goals of enhancing economic growth, reducing market inefficiencies, and particularly since the financial crisis, avoiding undue risk to the financial system and to European economies more generally.

[2]It is difficult to measure the specific effects of granting powers to shareholders, and in popular political debate, there is often an assumption that shareholder interventions are short-termist in nature and thus granting further powers to shareholders may not be good public policy. Empirical studies do not support this point of view. For example, Bebchuk, Brav, and Jiang (2015), in their study of shareholder activism, found "no evidence that [shareholder] activist interventions. . .come at the expense of long-term performance" (p. 1085). They conclude that claims of short termism "do not provide a valid basis for limiting the rights, powers, and involvement of shareholders" (p. 1085). More positively, Brav, Jiang, Ma, and Tian (2014) found that "firms targeted by. . .activists experience an improvement in innovation efficiency. . . . [and] increases in innovation output (as measured by both patent counts and citations)" (p. 1).

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The EU's approach to corporate governance policy has consciously steered clear of establishing a single EU-wide corporate governance code. This decision, in part, reflects the heterogeneity of the 28 individual countries, particularly in terms of corporate law and financial markets. It may also reflect a recognition at the EU level that there are strong similarities—and a tendency towards convergence—among the many individual corporate governance codes that are already in place.

Much of the regulatory framework emphasises disclosure and a comply-or-explain approach over hard law. In this context, the EU has embarked on a number of policies that address specific issues, including the following:

- Enhancing corporate transparency
- Protecting shareholder rights
- Enhancing board effectiveness
- Building shareholder engagement and stewardship

The predictable and reasonably transparent approach to the European corporate governance policy process since 2000 arises from what tends to be a slow and deliberate approach to policymaking. Typically, the process begins with the commissioning of studies; these studies then become consultative "Green Papers," which then are turned into "Action Plans," and then into specific Laws, Directives, or Recommendations in a process that can span several years.

The intentions and the evolution in thinking of corporate governance reform in Europe can best be observed in three Green Papers published in 2003, 2010, and 2011, which articulate the Commission's thinking at the time with regard to its broad philosophical approach and set the stage for further regulatory initiatives.

The 2003 Green Paper was an extensive review of corporate governance and matters of legal harmonisation that built from the High Level Group of Company Law Experts report (2002) commissioned by the European Commission in 2002. It helped to stimulate specific regulatory initiatives, such as the 2004 Transparency Directive and the 2007 Shareholder Rights Directive as well as European Commission Recommendations in the areas of boards and remuneration. This initial Green Paper also formed an intellectual foundation for the subsequent Green Papers on European corporate governance.

The financial crisis, which many believe was prompted by corporate governance failures,[3] had a profound impact in Europe on both financial markets and economies, and the effects linger to this day. The crisis and its immediate aftermath placed a greater emphasis on systemic safety rather than on enhancing business competitiveness. This emphasis led to a further review of fundamental principles and assumptions about corporate governance, including the premise of investor primacy. Michel Barnier, the commissioner for the Internal Market and Services Directorate General in 2009, was openly sceptical about the effectiveness of comply-or-explain systems and about relying on voluntary codes to ensure good corporate governance practice. He stated in 2010 that "I am clear that we will not be able to rely only on voluntary codes" (Doyle 2014).

Particularly given the harsh economic impact of the financial crisis, many governance issues became highly politicised and conventional governance practices came under question. For example, in 2010, the European Parliament, which expresses a broader range of views than the European Commission, expressed ethical, or "deontological," concerns about contemporary management and governance practices, such as executive remuneration and incentive systems, and the short-term perspectives of both companies and investors.[4]

Although the European Parliament is diverse in its composition, over time, it has established a clear stakeholder voice to add to the European corporate governance debate. In particular, it has had the effect of raising broad issues of how corporate governance should reflect a company's social performance and its impact on employees, stakeholders, and civil society in general. This perspective can still be found in the European Parliament through its advocacy of enhanced employee rights and gender diversity as well as through building greater awareness of social, ethical, and environmental issues affecting companies. This vision of corporate governance differs from the one that prevails in the Commission and is one that may challenge longstanding assumptions of shareholder primacy in the governance debate.

The 2010 Green Paper on governance in financial institutions and the 2011 Green Paper on listed companies both represent reviews on governance following the financial crisis, with both aimed at learning from past mistakes and exploring new approaches to avoid those mistakes in the future. The Green Paper on financial institutions stands out in terms of its approach to addressing systemic risk in the banking sector, and this risk focus led

[3]For example, Sir Christopher Hogg, chairman of the UK's Financial Reporting Council, the body responsible for oversight of governance in the United Kingdom, declared, "The credit crisis was the result of a massive failure of governance at every level" (Burgess 2009).

[4]See the European Parliament resolution "Deontological Questions Related to Companies' Management" (18 May 2010): www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2010-0165.

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to a prescriptive set of governance measures relating to remuneration and board practice in the 2013 updating of the Capital Requirements Directive (CRD IV). The degree of prescriptiveness in CRD IV, including the capping of bonus awards for bank executives, caused criticism in some circles.[5]

The 2011 Green Paper on listed companies was more general in scope, in many ways along the lines established in the 2003 Green Paper. Its broad themes of governance—boards, shareholders, comply-or-explain—remain on the regulatory agenda. However, the discussion became more detailed and granular on issues that include board composition and diversity, time commitment, board evaluations, shareholder engagement, and fiduciary duty.

The Corporate Governance Action Plan of 2012 stems from these Green Papers and is an important waypoint in the development of European corporate governance policy. It represents the Commission's most recent holistic assessment of the corporate governance challenges facing the EU and proposes 14 individual initiatives relating to corporate governance and company law. Many of these initiatives are focussed on enhanced disclosure requirements or address areas of corporate law harmonisation. Two of the fourteen initiatives represent proposed "hard" new shareholder rights; these initiatives relate to shareholder votes on remuneration policy and votes on material related-party transactions (RPTs).

Since 2012, similar to the 2003 Action Plan, there has been considerable focus on implementation of action steps through public policy. The most substantive of these is the multifaceted revision of SRD II introduced in 2014. SRD II not only seeks to enhance shareholder rights, but it also calls on institutional investors to play a more responsible role through stewardship practices, including voting and engagement.

SRD II is a complex omnibus piece of legislation with many points of detail. Some of its key provisions relate to shareholder votes on RPTs and remuneration, the transparency of institutional investors regarding their stewardship (voting, monitoring, engaging) activities, promoting shareholder identification, and facilitating the exercise of voting rights. On balance, SRD II has been supported by many investor groups; however, there remain divergent views on its detail.[6] The consultation process also resulted in a substantive proposal for amendments to the Commission's original SRD II proposal by the European

[5]European legal scholars have described CRD IV as "quack corporate governance" in part because of the lack of evidence that the proposed measures were likely to prove effective. For more information, see Zetzsche and Enriques (2014).

[6]For example, see comments from the International Corporate Governance Network (ICGN) in its letter "ICGN Comments on Proposals from the Council of Ministers (Council) and the European Parliament (Parliament) in Advance of the Trilogue Discussions" (www.icgn.org/sites/default/files/Revision%20of%20the%20Shareholder%20Rights%20Directive_4.pdf).

Parliament Committee on Legal Affairs. This European Parliament submission included 94 specific amendments relating to a wide range of issues, including issues—many with a stakeholder focus—that were not presented in the Commission's original SRD II revisions (European Parliament 2015).

One of the key new additions proposed by a number of members of the European Parliament for SRD II was for member states to promote long-term shareholding through such mechanisms as differential ownership rights, specifically relating to multiple voting rights. This initiative stemmed from similar legal provisions in France (the Florange Act) and in Italy (the Growth Decree). This proposal to spread such rights across the EU encountered significant institutional investor resistance by those concerned it would diminish accountability to minority investors, particularly in controlled companies.[7] The European Parliament ultimately did not adopt this proposal for amending SRD II. Another new addition put forward by a number of members of the European Parliament that was not in the Commission's original proposal relates to the inclusion of public country-by-country reporting, prompted to a large extent by the European Parliament's concerns about corporate tax policy and tax avoidance. This proposal was ultimately adopted by the Parliament. This issue proved to be contentious in the Trilogue (consisting of the European Commission, Parliament, and Council) negotiations on SRD II. At the time of writing, SRD II has not yet been passed into law.

One other major EU economic policy initiative by the Commission is the CMU. The CMU Action Plan was released 30 September 2015, and the ambition is to attract both direct and portfolio investment to Europe on the basis of more attractive capital market conditions. Key features of the CMU include developing broader financing alternatives to fund small and medium-sized enterprises (SMEs), including the use of bonds and other fixed-income instruments; to provide finance to corporations and green infrastructure; and to reinvigorate the practice of securitisation through a new regulatory framework for simple, transparent, and standardised securitisation. The CMU Green Paper of February 2015 (which preceded the Action Plan) recognises that "the protection of minority shareholder rights improves corporate governance and the attractiveness of companies for foreign investors." However, specific corporate governance issues, and their relationship to capital market developments, have received relatively little attention in this important policy initiative and were notably absent from the subsequent Action Plan.

Related to the CMU initiative is the Commission's ongoing focus on long-term and sustainable investment. The 2013 Green Paper "Long-Term Financing of the European

[7]See ICGN's letter to Věra Jourová, EU commissioner for DG Justice and Consumers, sent 29 January 2015: www.icgn.org/sites/default/files/EC%20-%2029.01.2015.pdf.

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Economy" and the subsequent 2014 "Communication on Long-Term Financing of the European Economy" both reinforce the CMU's emphasis on developing new sources of funding for long-term infrastructure initiatives and providing additional sources of financing for companies, particularly for SMEs. In a recent development, the Commission launched a public consultation on long-term and sustainable investment in December 2015. The Commission is seeking to understand specifically how institutional investors, asset managers, and other service providers in the investment chain factor sustainability (environmental, social, and governance, or ESG) information and performance of companies or assets into investment decisions.[8] The consultation also gathered information about possible obstacles to long-term, sustainable investment.

As of early 2016, SRD II is still being negotiated among the European Commission, Council, and Parliament (Trilogue), and the final outcomes of these revisions remain to be determined. The president of the European Commission, Jean-Claude Juncker, does not appear to be placing a high emphasis on new corporate governance initiatives, at least until the current Directives under discussion are complete.[9] Furthermore, the transfer of responsibilities for corporate governance from the finance to the justice directorate, and along with that change, a change in the parliamentary committee that oversees governance, may mean that there is a drift away from seeing governance as a lever in economic policy towards a view in which social issues may take a higher profile.[10]

In terms of the specific issues, the broad philosophical starting points of the Green Papers and their progression to the Corporate Governance Action Plan of 2012 and SRD II have evolved into technical debates on a few specific themes, which currently include the following:

- Shareholder rights to vote on material RPTs
- The right to vote on remuneration policy
- Heightened transparency for both proxy advisers and institutional investors

[8]The response of CFA Institute to the consultation is available at www.cfainstitute.org/Comment%20Letters/20160325.pdf.

[9]At the same time, however, the European Parliament is keen on developing the dialogue on corporate governance.

[10]The European Commission classifies its governance policy activities in broad categories, including directors and board members, shareholder rights, employee share ownership, remuneration policies, transparency, and financial institutions. See the Commission's list of a comprehensive set of references to Directives and Recommendations in these areas: http://ec.europa.eu/justice/civil/company-law/corporate-governance/index_en.htm.

- Differential ownership rights as a means to promote long-termism
- How to fix the "plumbing" of cross-border proxy voting
- How to achieve shareholder identification to facilitate company engagement with shareholders
- Board diversity, particularly the role of women on boards
- ESG risks and other nonfinancial risks in company disclosures and in responsible investment practices
- Country-by-country reporting, in part to provide greater transparency in terms of a company's corporate tax policy

Outside of the formal public policy process, focus is building in many investor, company, and regulatory communities about the role of culture, behaviour, and ethics in terms of shaping responsible corporate governance and investment practices. This focus suggests less reliance on traditional features of corporate governance codes or public policies and raises questions about the extent to which policy initiatives can meaningfully address qualitative or behavioural issues, such as corporate culture and conduct risk, and the degree to which regulators can have confidence in the integrity of the system and be encouraged not to overregulate.

There is thus a potential tension in the development of corporate governance policy. With SRD II completed, the EU policy direction appears to lack a cohesive vision.[11] Furthermore, there are voices that may call for an implicit, or even an explicit, change from currently accepted norms from a shareholder perspective. For example, differential voting may be promoted to encourage long-termism, controlling shareholders may be protected to encourage more companies to access public markets, and so on. This is why we argue the EU stands at a crossroads, with important questions to answer about the future direction of corporate governance—including how it is coordinated across the directorates involved with governance policies.

[11]There arguably had been a clearer vision under the Barnier plan (although not one that investors generally supported).

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III. Where Are We Now? Input from Workshop Discussions

As part of the workshops, participants were asked to review three specific topics: (1) the key initiatives that they would like to see explored, (2) their view of the role of European policymakers, and (3) the role of investors. They were also encouraged to share any other comments they felt were germane to the discussion. These themes are discussed in the following sections.

Discussion Theme 1: Policy Initiatives

All the investor workshops raised consistent themes in their assessment of shareholder rights in Europe. General concerns focussed on the disparity of governance standards and rules across Europe and on the challenges that minority shareholders face relative to controlling shareholders. However, there were also specific issues that were raised by participants or that moderators raised with them. These issues can be grouped under the following general headings:

a. **[Infra].** Ensure proper infrastructure and momentum to make practical the vision that has underpinned governance interventions to date

b. **[Min].** Protect minority shareholders

c. **[Acc].** Ensure the accountability of boards

d. **[Stk].** Incorporate stakeholder concerns in the governance agenda

Important Issues Raised

In the following sections, we discuss the various topics raised in the order of the importance that seemed to be attributed to them by our workshop participants. In each case, we have noted the heading applicable to each topic.

Accountability of Directors [Acc].

In each workshop, investors emphasised the importance of being able to hold directors accountable. The ultimate ability of investors to hire and fire the board is fundamental to bring accountability to both executive and non-executive directors. However, particularly given controlling owners and the existence of shares with multiple voting rights, many minority shareholders are concerned that the playing field is not level, nor will it be so after SRD II. Specific areas of improvement would be consistent proxy access rules across Europe that would allow minority shareholders to propose independent candidates for the board.

Although some in the workshops questioned the effectiveness of independent directors, others noted that independent directors are ultimately critical to board effectiveness and are in some ways the first line of defence for minority shareholders to ensure that minority rights are respected by the controlling shareholder. In this context, one of the investor groups suggested that SRD II might have missed an opportunity to call for a provision that director candidates must win a majority of the minority shareholders.[12]

Another potential area in which accountability could be strengthened would be for greater policy clarity on the rights of shareholders to engage with a company's non-executive directors as well as with a company's executive management. Practice across Europe is inconsistent on this point, and in some jurisdictions non-executive directors rarely, if ever, meet with the company's shareholders. This issue would also fall under the **[Infra]** heading.

Related-Party Transactions [Min].

RPTs were identified in each workshop as a critical minority investor right in light of the interests of controlling owners. An independent shareholder vote on material RPTs is supported by most institutional investors as an important area of governance harmonisation, even though there may be differing views on how to define materiality. Although a right of this nature was originally proposed by the European Commission in SRD II, the proposal met resistance from both the corporate community and, within the Trilogue, from both the European Parliament and Council. A dilution or removal of this RPT proposal from the final SRD II provisions would be a disappointment for institutional investors and would underscore and give rise to ongoing concern about the potential abuse of minority shareholder rights by controlling shareholders.

[12]Under the **[Min]** heading, at a recent (March 2016) ICGN conference in Frankfurt, another investor representative (not present at the CFA Institute workshops) commented that SRD II could also have added a requirement for a relationship agreement between controlling shareholders and the company to frame the controlling shareholders' approach to intervention and protecting the rights of minority shareholders.

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Differential Ownership Rights [Min].

Concern about differential ownership rights, embodied in particular in the Florange Act in France, surfaced in each workshop group. But the concern is relevant not just in France, but in all jurisdictions, particularly ones in which controlled ownership is the norm. Investors expressed relief that the inclusion of differential ownership rights—initially proposed as an amendment by the European Parliament—was removed from the SRD II discussions. But nonetheless, investors remain concerned that this issue could again resurface in Europe. There was a resolute view expressed that differential ownership rights undermine executive and board accountability to minority investors and exacerbate concerns about disproportionate powers of controlling owners.

However, when the debate was put to workshop participants, they recognised that differential ownership rights may have a legitimate role to play in the life cycle of companies, particularly as smaller companies are nurtured for public listings. But the imposition of ownership rights as a default structure, without a sunset clause, for all public companies—as in France through the Florange Act—is viewed in the investor community as retrograde and fundamentally flawed through its entrenchment of vested interests.

Exercise of Ownership Rights through Voting [Infra].

Even though the problems of cross-border voting were flagged as needing urgent attention in the High Level Group of Company Law Experts report of 2002, the investor workshops all flagged ongoing deficiencies in the "plumbing" as problematic and still requiring attention. This call was not for any extension of rights but simply a desire to make practical the rights that are already granted—for example, through the timing of general meetings, the information flow to shareholders about the meeting and its agenda, and the ability of investors to receive confirmation that their voting instructions were received and processed in the final vote.

A particular challenge lies in the area of cross-border voting, which is increasing in relevance given the internationalisation of shareholdings, particularly in the main European equity markets. To avoid disenfranchising nondomestic shareholders, it is critical for them to receive information on a timely basis relating to shareholder meetings and voting matters—and to be able to submit votes electronically by proxy. Otherwise, there are serious implications for the fair functioning of capital markets and the efficacy of the European corporate governance framework. The intent of the CMU initiative should to be to harmonise standards across aspects of market activity, and there is logic for voting reforms to be taken up under the CMU umbrella.

Other Issues Raised

The following sections cover other themes mentioned in the workshops but with lesser emphasis.

Remuneration [Acc].

The theme of remuneration cropped up in each workshop, but in each case, the workshop participants downplayed the importance of remuneration in the mix of corporate governance issues in Europe, although it still remains problematic, particularly in the banking sector. There was a clear view that compared with other issues, including shareholder rights, audit, disclosure, and risk management, remuneration is only of secondary importance. Investors do generally support the shareholder vote on pay, as proposed in SRD II, as a good minimum standard and believe that it should not be diluted. But the participants also recognised that the vote on pay is time and resource intensive and can create distractions for investors as well as distort engagement dialogue towards pay and away from potentially more pressing governance concerns.

Company Disclosure [Acc, Stk].

Investors expressed a growing focus on elements of disclosure that reflect drivers of company value, including indicators of less traditional factors, such as company business models and company culture. Increasingly, this points to the importance of ESG factors and the need for integrated reporting of them, given the growing visibility of company social performance and the effect of stakeholder relations on a company's purpose and ability to create long-term value. Although ESG itself did not feature as a standalone theme in the broader investor discussion, there was recognition that ESG factors can be material and relevant to the companies' bottom line. ESG issues may have particular importance in assessing stakeholder relations. The need for shareholders to understand and respect stakeholder concerns was addressed in the workshops.

Electronic Disclosure and Harmonisation [Infra].

Although the institutional investor community is often critical of the lack of shareholder rights offered by companies in the United States, one workshop group pointed to the harmonised US disclosure regime as a positive model for Europe to consider. In particular, the standardisation of annual reporting through the US SEC's 20-F reports and field coding in the SEC's EDGAR database facilitate investor analysis, particularly the comparative analysis between companies. This standardisation is not yet available in Europe, but one workshop participant noted that ESMA is working on a similar harmonised

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electronic disclosure format and centralised repository for corporate filings that is required to be produced by 2020.

Takeover Rules [Min].

Two of the workshop discussions made reference to the protection of minority shareholders in takeover situations, which points to the potential for a review of the Takeover Directive. However, there was not a consistent investor view that there is a need for takeover rule harmonisation across Europe.

Issues Not Raised

It is also worth noting specific themes that were not raised in the investor workshops, even though these issues were identified in the background note and in a presentation at the outset of the workshops. This does not suggest these issues are unimportant, but it may suggest that they do not count among the most critical investor concerns relating to European corporate governance.

Board or Gender Diversity [Stk].

The main investor discussion on board composition focussed on independence, not diversity. Most institutional investors are supportive of initiatives to enhance board diversity, and gender diversity has been a particular area encouraged by investors. Many investors are calling for companies to be more transparent in articulating a board diversity strategy and targets, but at the same time, they are often wary of the unintended consequences of imposing fixed quotas.

Shareholder Identification [Infra].

The issue of shareholder identification is a feature in SRD II, primarily as a mechanism to allow companies to know who their investors are and to help facilitate engagement. Many investors are open to shareholder identification, although some believe there should be a threshold limit (0.5% of a company's equity base is sometimes cited as a threshold). To the extent that shareholder identification in SRD II comes to pass, investors also believe that this information should not only sit with the company; it should be accessible by all investors to facilitate collective engagement. Indeed, it is difficult to see how shareholders can perform their role as responsible owners if they are unable to identify who the other shareholders are.

Country-by-Country Reporting [Stk].

Public country-by-country reporting was not on the original SRD II document put forward by the European Commission. It was subsequently put on the agenda by the European Parliament on the basis that this form of reporting could provide better transparency with regard to a company's tax policies and potential tax avoidance. It is understood that resistance to country-by-country reporting is a key issue holding up final resolution of SRD II. This issue is of greater immediate concern to companies than it is to investors. But investors have begun to recognise that corporate tax policy can create significant reputational risk for companies and affect key stakeholder relations; investor groups have begun to call on company boards to build awareness and oversight of these issues as a matter of corporate governance. However, the fact that country-by-country reporting did not crop up in any of the investor workshops suggests that investors do not believe that this disclosure would feature significantly in their own investment analysis. Civil society groups may be better positioned than investors to serve as watchdogs, making use of country-by-country reporting to call companies to task for questionable tax practices.

Discussion Theme 2: European Law and Regulation

Hard Law vs. Soft Law

In general, there was recognition in the investor discussions that for many governance issues, the most appropriate policy approach should be based on principles—and hence the "soft law" of comply-or-explain—rather than black letter law and regulation. However, the discussion was nuanced.

Workshop participants from the United Kingdom and the Netherlands said that comply-or-explain codes work reasonably well in those countries, assisted by the existence of a monitoring capability in both jurisdictions. It is also the case that investor engagement with company management and board directors is well established in these countries. However, consistent with the recurrent theme of minority shareholder protections vis-à-vis controlling shareholders—a model of ownership often prevailing in southern and eastern Europe—investors did question the ultimate effectiveness of a comply-or-explain regime in jurisdictions where controlled companies are the norm and a culture of stewardship or engagement has not yet taken root. In this environment, there is the potential for companies to ignore governance concerns of minority shareholders if the controlling shareholder sees no reason to encourage compliance.

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In situations involving controlling shareholders, the lack of an enforcement mechanism was seen as a weakness of comply-or-explain, which resulted in some investors calling for minimum corporate governance standards or tougher enforcement laws at the European level. But mixed views were expressed about the benefits of further governance harmonisation in the EU. One participant based on the continent and speaking to the benefits of greater harmonisation noted that any changes to pan-EU corporate governance rules should start with requirements for independent directors. Other participants were wary about attempts for further harmonisation, fearing that it could lead to lower base standards to establish an acceptable common denominator across a very diverse group of countries with differing governance traditions. Indeed, one of the "horror scenarios" expressed by investors was related to the potentially inappropriate regulatory prescription of corporate governance practices.

Participants were consistent in their discussion of culture as a new focus in corporate governance. Investors are increasingly paying attention to company culture as an indicator of good management practices and stakeholder relations or as an indicator of potential business risks. But company culture itself lies beyond the bounds of regulatory orders. As one participant noted, "You can harmonise law, but you cannot harmonise culture." However, to facilitate understanding of culture by investors and other stakeholders, the EU can continue to press for greater and more consistent ESG disclosures relating to a company's social, ethical, and environmental practices.

Governance of Banks

The banking sector did not feature prominently in the discussion, but there was general recognition that its systemic risks justify a more rule-based and risk-averse approach to governance. It is clear that regulators and bank supervisors should play a more active role in governance oversight for banks relative to other sectors. But this cannot be to the exclusion of banks building investor relations and engagement. For a private sector banking system to be healthy, banks need to have access to institutional investor capital. Hence, the needs and concerns of investors cannot be ignored. In this context, many investors are critical of the blunt regulatory requirements of CRD IV for European banks, and concern was expressed about any attempt to extend a more prescriptive governance framework beyond the banking sector.

Discussion Theme 3: The Role of Investors

Regulatory Expectations of Stewardship

The institutional investors taking part in the workshops all represented firms with committed resources to governance and stewardship activities; indeed, most of the investors in the workshops were those charged with undertaking these activities on a day-to-day basis. The participants, therefore, were understandingly supportive of investor stewardship, and the discussion benefitted from first-hand knowledge of its achievements and limitations.

Although investors generally support SRD II and its focus on investor responsibilities, there was also concern expressed about the practicalities of transparency disclosure by institutional investors, particularly for larger investors offering a large number of funds and fund strategies. Different fund strategies may differ in terms of the individual fund's mandate, and the reporting to clients and end beneficiaries will thus differ from fund to fund. These differences do not always lend themselves well to summary presentations with regard to engagement and investment strategy. Disclosure could thus be unduly granular and complex or generalised to watered-down disclosures. This possibility gives rise to the underlying concern about what the regulatory expectations are with regard to investor stewardship: What are the outcomes expected from SRD II?

The potential for a disconnect between regulatory expectations and investor stewardship capabilities prompted several investors to seek greater clarity in terms of what the EU's expectations are with regard to investor monitoring, voting, and engagement. In particular, there was the suggestion that there be a greater focus on the specific role of the asset owner as well as clarification of the expectations of asset managers.

Institutional Investor Business Models and Stewardship Resource

The investor participants noted that human resources for stewardship activities are building but are still relatively limited—and arguably under-resourced in many cases. This situation is particularly true for institutions with widely diversified holdings, which are often managed through passive index funds. In such cases, an institutional investor may have holdings in hundreds, very often thousands, of companies. Even when dedicated stewardship resources exist within the institutions, they are often unable to monitor or engage with every company they hold in their portfolios. Resources tend to be applied selectively rather than across all investments. Individual holdings can be prioritised for any number of reasons, which include the stake held in the company, the potential for positive change

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through engagement, the company's prominence or visibility in the market, or the severity of a governance issue in which engagement is clearly called for.

Although investor efforts continue to build in this area, business models of many institutional investors—particularly those with large passive strategies and widely diversified holdings—limit the incentive to invest resources in stewardship. The result may be lumpy monitoring and engagement as well as inconsistent monitoring across all issuers in the market. Resource constraints are likely to remain if there is little incentive—or pressure—to commit to this activity.

Apart from EU transparency requirements on stewardship through SRD II, a key motivator for enhanced stewardship must ultimately come from asset owners. Pension funds must hold asset managers accountable, and pension fund trustees must hold pension funds accountable—all on behalf of the long-term interest of the end beneficiaries. But even with greater transparency and disclosure, it may be the case that the business models of some institutional investors do not provide for comprehensive stewardship activities in all managed portfolios. Unless stewardship is systematically integrated into institutional portfolios and investment management agreements as an industry standard, the potential for positive governance outcomes will diminish.

Discussion Theme 4: Markets and Politics

Capital Markets Union and Corporate Governance

Participants were generally supportive of the CMU initiative and saw merit in the focus on long-term financing and sustainable investment. At the same time, it was observed that corporate governance issues did not feature meaningfully in the Green Paper or Action Plan. Some investors see this omission as a missed opportunity to introduce basic governance standards (voting, director nominations, and other shareholder rights). The goals of the CMU are sensible, particularly with regard to making Europe's capital markets more attractive and competitive globally and to attracting portfolio investment flows from other jurisdictions. However, harmonised market standards alone do not make European markets more attractive: There must be attractive companies to invest in as well. In this context, investor concerns about the rights of minority shareholders in many European jurisdictions may inhibit the attractiveness of companies listed in these markets, which is a potential blind spot of the CMU, or a hole that is consciously not being addressed.

Position of Corporate Governance in the Commission

Linked to the investor concern about the limitations of the CMU, the reassignment of the corporate governance team to DG JUST (Justice and Consumers) from DG FISMA (Financial Stability, Financial Services, and Capital Markets Union) raises questions about the cohesiveness of the corporate governance agenda in the European Commission. DG FISMA oversees bank governance through CRD IV; DG JUST focusses on legal issues, the governance of listed companies, consumers, and gender equality. With DG FISMA leading on the CMU and DG JUST leading separately on SRD II, these initiatives appear to be developing in parallel with one another but with apparently limited interconnection and the lack of a commonly shared EU policy vision across the Commission.

Brexit

Because of the timing of our workshops, in early 2016, the subject of Brexit (the possibility of the United Kingdom withdrawing from the EU) came up. Most participants expressed concern about the impact that Brexit might have on EU corporate governance policy. Comments from continental-based panellists ranged from "highly detrimental" and "devastating" to "horror scenario." Several continental panellists pointed to UK leadership in the area of corporate governance as a positive example in the EU, and concern was expressed that its influence would diminish if Brexit were to occur. The sentiment suggests that, despite its flaws, aspects of the UK corporate governance system enjoy considerable support among investors in many EU nations.

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IV. Conclusions from Part One—European Corporate Governance Past and Present: Where Are We Now?

From the four discussion themes that came out of the workshops, we draw several conclusions to consider in thinking about the future EU policy direction in corporate governance.

- **Progress has been made in Europe since 2000, but there is still unfinished business.** The EU policy process has progressively introduced Green Papers and Action Plans that have led to positive developments in shareholder rights, voting, corporate disclosures, and recognising shareholder responsibilities. But there are still a number of actions that could be taken to ensure that the intentions of this legislation are fulfilled. These include the following:
  - Clarifying the intent of SRD II in terms of expected behaviour by investors
  - Monitoring compliance with governance standards
  - Simplifying the exercise of ownership rights, particularly across borders
  - Harmonising reporting and disclosure standards, including nonfinancial reporting
  - Identifying shareholders
- **Shareholder rights remain a key concern, particularly for minority shareholders in controlled companies.** SRD II may be the end of the current wave of governance regulation, but it has not addressed the shareholder rights issue. The only "hard" shareholder right that SRD II could produce is the right to vote on remuneration policies. Investors had a series of requests to help protect minority rights, including the following:
  - Develop rules on RPTs, including shareholder votes and definitions of materiality
  - Harmonise minority protections in takeovers

- Discourage differential ownership rights and encourage a balanced debate on their potential merits and ill effects
- Encourage independent director appointment mechanisms
- Clarify definitions of independence

More broadly, participants were in favour of ensuring greater director accountability to investors, including the following investor rights:

- The right to appoint directors
- The right to vote on remuneration policies (less consensus on binding versus nonbinding)

- **Comply-or-explain remains supported by investors, but it is recognised that it can be ineffective without strong monitoring or an enforcement mechanism.** Investors generally appreciate the merits of flexibility provided by a comply-or-explain regime to allow companies to adopt the most suitable governance framework for their own particular needs. But this flexibility also raises the potential for abuse, particularly given concerns about imbalanced shareholder rights and controlling shareholders who may be unsympathetic to corporate governance standards or the considerations of minority shareholders. A critical feature of making comply-or-explain work effectively is a credible monitoring capability or organisation. Monitoring systems of governance compliance differ across Europe and are often organised on a voluntary, not obligatory, basis. In some jurisdictions, they have yet to be implemented.[13] It is certainly an aspiration embodied in SRD II that institutional investors will play an important role in monitoring and engaging on governance matters. There may be more to be done here to encourage investors to build capabilities to exercise stewardship obligations, proportionate to the investor's size and complexity, alongside traditional portfolio management activities.

- **Can investors play the role they are expected to play in a comply-or-explain governance regime?** Many investors would argue that without adequate shareholder rights, monitoring and engagement are unlikely to provide an effective discipline to ensure good company governance. This lack of rights amounts to responsibility without authority, particularly in the case of controlled companies. At the same time, concern was expressed that investors have already been given rights and powers that they do not always take proper advantage of, and that if they do not exercise their rights, investors will increasingly be "seen as irrelevant by policymakers." There is work to be done on all levels.

[13]See ecoDa and Mazars (2015) for more information.

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Policymakers in the European Commission and European Parliament will need to understand the complexities of large institutional investors and the practical limitations of stewardship. Companies, as part of the stewardship ecosystem, will need to show a willingness to engage and to allow for investors to meet with nonexecutive directors. In turn, institutional investors will need to explore business models and internal governance to establish more effective and efficient responsible investment practices. All participants will also need to demonstrate some patience until the evidence base on stewardship becomes clearer; this is unlikely to be a quick fix. As the UK's Financial Reporting Council noted in a report published five years after the launch of the UK Stewardship Code, "the development of a culture of stewardship may take time" (2015, p. 17).

- **Capital Markets Union is a worthy aim, but the absence of a corporate governance dimension may be a blind spot.** This issue is a particular concern with regard to minority shareholder rights and making controlled companies attractive to foreign investors. Differing corporate governance regimes across the EU are recognised as a reality, although the inconsistency of governance standards remains a complication and an investor concern. This inconsistency does not appear to feature in the thinking of policymakers in their approach to the CMU, even though harmonisation of voting standards across European markets seems to be a specific area to which the CMU initiative could extend.

Part Two

V. The Future of Corporate Governance Reform in Europe

Shareholders, Stakeholders, and Open Markets

As discussed in Section II, European Union corporate governance reform since 2000 has been a process that in broad terms has aimed to promote a system in which companies are transparent about their operations and are overseen by accountable boards who are elected by and report to shareholders. Although the response to the 2008 financial crisis was more *dirigiste*, or hard-law focussed, than investors might have welcomed—particularly in the banking sector—the general direction of EU policy has supported shareholder rights. In other words, the historical agenda has been quite compatible with institutional shareholder powers and shareholder primacy.

As discussed in Section III, the results of the workshops suggested, unsurprisingly, that institutional investors would support a continuing process of the extension of such rights, particularly for minority shareholders. And following a similar rationale, policymakers might be inclined to ask the shareholders who have had their rights strengthened to accept the responsibilities that come with such rights—for example, by demonstrating the proper exercise of those rights, by demonstrating good stewardship of companies, and by perhaps incorporating environmental and social considerations as well as financial ones in investment and engagement processes.

Although there are many practical questions about how such responsibilities might be defined, the judicious extension of shareholder rights and responsibilities would be compatible with investor primacy and a broad fiduciary stewardship role for institutions as discussed in Section III. It would also be compatible with the direction of research evidence that, although far from definitive, suggests that extending shareholder rights has been associated with more profitable, productive, and focussed companies.[14] The principal

[14]For evidence of shareholder activism, see Footnote 2. The evidence on banks is limited; however, Berger, Imbierowicz, and Rauch (2016) suggest that banks in which mid-ranking officers were incentivised through share ownership were more likely to default.

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exception in the research is that those banks that encountered difficulties in 2008 were those that had been more open to shareholder influence, which may give some justification to the EU's response to the financial crisis in the banking sector.

We concluded from our discussions with the Commission and other policymakers that the current phase of governance reform is coming to an end once SRD II is resolved. The proposals that are currently on the table are arguably disparate[15] and do not appear to represent a cohesive vision for the future of corporate governance in Europe. Furthermore, within the Commission, there have been institutional changes that could disrupt the consensus that has underpinned the extension of investor rights—in particular, the change in responsibility for corporate governance within the Commission from the old Directorate-General for Internal Market and Services (subsequently the Directorate-General for Financial Stability, Financial Services, and Capital Markets Union, or DG FISMA) to the Directorate-General for Justice and Consumers, or DG JUST.

More broadly, we recognise that investors are not the only interest that companies need to consider in managing their affairs. Any discussion of corporate governance must begin with an understanding that, within Europe, there are different views concerning the question of why companies exist and who companies should serve and be accountable to. There are different visions, and shareholder or investor primacy is not the only model competing for policymakers' attention.

In our discussions with policymakers and others, we identified three broad perspectives on how corporate governance should be approached. Each of these is a legitimate and sophisticated point of view; the art of good policymaking is to find a way to reconcile the best from each. Therefore, one aim of our investor workshops was to understand where institutional investors are positioned relative to these three models. The models are described in simplified terms in the following.

1. **Shareholder primacy**. The traditional perspective of institutional investors has been based on shareholder primacy. Hence, governance systems should reflect prioritising their interests over other stakeholders[16] and seeking other protections for creditors, workers, and other societal interests. This model is consistent with both granting rights to shareholders and having shareholders exercise these rights responsibly through good stewardship practices.

[15]See Hopt (2015) for more information.

[16]For example, in the United Kingdom, Section 172 of the Companies Act enjoins directors to run the company in the interests of "the members as a whole," albeit with the important caveat that they have considered the effect of their actions on other stakeholders.

Those supporting the shareholder model emphasise that shareholders have legal rights; in aggregate, shareholders own the company, and these rights should be respected. From a pragmatic point of view, this model has underpinned companies that have proven to be the engine of growth in Western economies (consumer- and worker-controlled businesses have proven less dynamic).

Furthermore, because most European households have private pensions and other savings, the exercise of shareholder rights is not, as is often assumed, the exercise of powers by a wealthy minority. Indeed, it could be considered quite democratic and quite capable, on behalf of millions of "beneficial owners," of promoting social and environmental issues as well as stimulating economic growth.[17] The shareholder primacy perspective might argue for the protection of shareholder rights, encourage the adoption of stewardship codes, promote company and investor disclosure on ESG issues, and such other similar reforms.

2. **Stakeholder primacy**. Shareholder primacy can be challenged by those who believe that companies are a legal creation that should be able to demonstrate social purpose beyond simply serving private shareholders, and hence other interests need to be incorporated in the governance system.[18] But ultimately, this perspective extends to civil society more broadly. Many stakeholders may believe that the "animal spirits" of institutional investors cannot be trusted to provide companies appropriate long-term support and may be wary of the benefits of providing shareholders with additional rights.

   Promoters of the stakeholder model would point to the huge influence of corporations on civil society and their need to demonstrate that they are accountable to those whose lives they affect. They would also note that in Germany, where workers are entitled to a role on the supervisory board, it has not had negative economic consequences. Indeed, stakeholders may often be more likely to take a longer-term view of the value of a company than institutional shareowners do, who can, and often do, hold company shares for only a very short time. Supporters of the stakeholder position might advocate for a better social balance on the board—for example, by encouraging women or workers as directors. They might also advocate for greater stakeholder access to corporate decision making.

[17]The importance of "the citizen investor" is argued for in one of the authors' publications (Davis, Lukomnik, and Pitt-Watson 2006) and by many practitioners; for example, see Aviva's report (Waygood 2014).
[18]Notably, in Germany, employees are represented on the supervisory board, albeit it is typically only domestic workers, represented through a works council, who enjoy that privilege.

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3. **Open markets, independent companies**. The open market perspective has a different starting point. This view is that companies are there to fulfil a purpose, which in aggregate might be to "grow the economy in a sustainable fashion." The purpose of capital markets is to provide capital resources efficiently in support of that goal. This perspective is agnostic about shareholder or stakeholder interests *per se;* its focus is more on the economic goal of promoting the success of the corporate entity itself.[19] Investors are there to provide funds to companies on appropriate terms, and although those terms might reflect the governance of the company, there is no need for extensive rules that define "good governance." That defining may be best left to the market, and indeed, market forces might be a better way to encourage good governance rather than normative legislation by policymakers or standard setters. The key focus of this view is ensuring that capital is used efficiently and transparently and promotes the goals of broader economic growth and financial stability.

   This perspective is germane in the light of the CMU initiative. The CMU reflects European concerns about gaps in the provision of capital to promote sustainable growth. Compared with other global capital markets, most notably the United States, relatively little capital is available to smaller enterprises. Some companies have delisted from public stock exchanges because of the onerous conditions of accessing public financing. Investors may appear short term, and under this influence, stock market companies are returning more cash than they raise. From this perspective, rigid governance rules may be exacerbating the problem.[20] Rather than insisting on somewhat onerous minimum standards for all companies, investors should be pricing governance factors into their investment decisions. Thus, poorly governed companies could access the market, albeit at a cost, and this cost would create an incentive for good governance. This perspective might suggest a more pragmatic approach to governance standards. For example, dual voting might be deemed acceptable to encourage family companies to access the markets or long-term shareholders to exercise greater influence. It might be considered constructive to have different governance regimes for different types of companies, such as for banks.

All these perspectives have logic and legitimacy, and all the institutions we spoke to recognised that. However, in talking to the Commission about its views, we noted the importance of the shareholder; the European Parliament emphasised issues associated with the stakeholders, and the OECD focussed on issues associated with the open market perspective.

[19]This is a view articulated by Berle and Means (1932) in their book *The Modern Corporation and Private Property* and also reflected in the writings of British economist John Kay.
[20]See, for example, Isaksson and Çelik (2013).

If these different approaches are seen as being in conflict, it might suggest an impasse with regard to the development of more unified governance standards. That position is illustrated in Panel A of **Figure 1**. Any proposal that would promote one of the three perspectives *in extremis* is in conflict with the others.

But these three perspectives do not need to be in complete conflict. Differences in perspectives may simply cloud a broader agreement about practical outcomes. Although there may be disagreement in how governance is structured, most agree that the aim of the system should be to create companies that produce long-term sustainable returns through the provision of valued goods and services and that this goal should be accomplished with proper regard for stakeholder interests and without undue detriment to society and the environment.[21] Governance, however it is structured, is a means to that common end.[22] This situation is illustrated in Panel B of Figure 1.

[21]The legal definition of directors' duties in Section 172 of the UK Companies Act is one example of an attempt to reconcile stakeholder and shareholder claims. A similar observation could be made of the Hermes principles, which explicitly ask, on behalf of an institutional investor, that companies consider and address the just claims of stakeholders. See www.ecgi.org/codes/documents/hermes_principles.pdf for more about the Hermes principles. ICGN's Global Governance Principles also make reference to the responsibility of directors to have regard for stakeholders in the context of generating and protecting sustainable value for the company over the long term. See www.icgn.org/policy.

[22]A mathematical analogy for a way that shareholder primacy could work in the context of stakeholder and market forces might be in the area of linear programming—solving systems of equations subject to constraints. In this context, the shareholder primacy advocate might call for shareholder returns as the variable in the objective function to be maximised (as the "right-hand side of the equation"). But in a governance system in which stakeholder and market pressures exist as realities, these factors can be regarded conceptually as binding "constraint functions" that first must be satisfied before a feasible solution relating to shareholder returns can be realised. This approach effectively amounts to optimising shareholder returns subject to satisfying these stakeholder and market constraints rather than simply maximising shareholder returns. In other words, long-term shareholders must realise that if a shareholder model is to prevail, then companies cannot cut corners with stakeholder obligations and economic efficiency.

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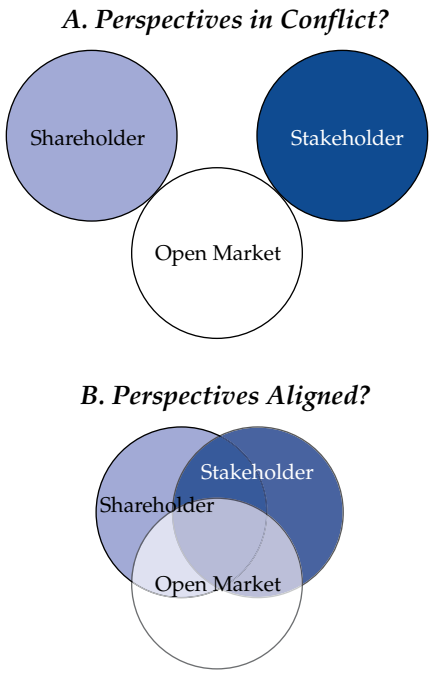
Figure 1: Three Perspectives: Shareholder Primacy, Stakeholder, and Open Market



Workshop Results

As part of our work, we explored whether there might be a consensus that could be reached among these three perspectives, at least with regard to individual issues. If these perspectives cannot be brought into harmony, then future policy development will be beset by conflict. But if consensus can be reached, then it suggests there would be more fertile ground for progress.

To assess the level of consensus among the three perspectives, we asked our workshop participants to gather in small discussion groups and to evaluate their responses to a range of competing propositions relating to corporate governance and investor responsibility. For example, one proposition aimed to realise the degree to which the investor and stakeholder perspective might be aligned. It asked participants, all of whom came from the investment community, to choose between Proposition X, which suggests alignment with stakeholders, and Proposition Y, which suggests conflict:

Shareholder Primacy, Shareholder Rights, and Stakeholders

- Proposition X: Companies are there to make money for investors. That is why we invest in them. Asking them to do more is a costly burden, which is usually against shareholder interests.

- Proposition Y: Institutional investors are fiduciaries. On behalf of their clients, they should ask companies to reflect broader social norms and obligations. In any case, this rarely hurts profitability.

Table 1 shows the outcome of this discussion. Our workshop participants were clearly of the view that they were fiduciaries and needed to promote broad stakeholder interests as part of their fiduciary duty to clients. In the table, the line represents the "average" position[23] and the dots represent the position of different discussion groups.

[23]Note that the precise position of the group positions has been taken from worksheets that were completed following group discussions. The "average" is an estimated figure. When groups did not agree or report a position, these have been ignored. The results should thus be viewed qualitatively.

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Table 1. For the Competing Propositions X and Y, Which Best Reflects the Group's Own View?

Proposition X	Strongly prefer proposition X to proposition Y	Tend to prefer proposition X to proposition Y	Tend to prefer proposition Y to proposition X	Strongly prefer proposition Y to proposition X	Proposition Y
Companies are there to make money. That's why we invest in them. Asking them to do more is a costly burden which is usually against shareholder interests.					Institutional investors are fiduciaries. On behalf of their clients, they should ask companies to reflect broader social norms and obligations. In any case, this rarely hurts profitability.
Shareholders are the owners of companies, and boards should serve them. That's what capitalism means!					There are other stakeholders in company activities. Of course they should have access and influence in company decisions.
Shareholder rights are fundamental. That is true whether or not that leads to companies which create more value.					Companies should be delivering long-term value and be subject to proper financial disciplines. We should be open minded about how that is achieved.

● Individual Observation —— Workshop Average

Table 1 also shows two other propositions that were designed to determine where consensus and conflict might lie. The results reveal that the participants had a general willingness to respect the needs of other stakeholders but not to renounce any shareholder rights. Participants were equally balanced in supporting the proposition that boards should serve shareholders and that other stakeholders should have some influence in company decisions. The results suggest that, as far as they are concerned, there is a considerable overlap between the shareholder and stakeholder perspectives. The participants' strong support for shareholder rights could thus be considered consistent with a broader responsibility to

stakeholders. For example, shareholders can, and do, engage companies to factor stakeholder concerns into company strategy and operations.

How Important Is Investor Stewardship?

We then went on to quiz workshop participants on the practicalities of giving responsibilities to institutional shareholders. Many institutional shareholders are very broadly diversified, owning shares in as many as 8,000 companies. To be a "good owner" of such a large number of enterprises requires considerable resources and skill. There are considerable practical problems with institutional investors' ability to act as owners, which have become apparent as the call for institutional stewardship has grown. Often, it is assumed that investors can make informed governance decisions and exercise their rights appropriately. However, modern portfolio theory and investment practice make it difficult, particularly with the growth of passive index funds. There is a focus on diversification with a tendency towards shorter holding periods for shareholdings and the use of derivatives, thus separating economic ownership and control. Furthermore, the number of investment intermediaries often undermines both the practicality and the incentive for investors to be "good owners."

So, we asked workshop participants two questions about the practicality of institutional investors assuming ownership responsibilities and their role relative to others in the governance ecosystem. For example, participants were asked to choose between Proposition X, which suggests a limited role for shareholders, and Proposition Y, which suggests a more central role.

- Proposition X: Stewardship is a nice idea. But institutional shareholders have only limited resources to carry out that function. You cannot place too much of a burden on them.
- Proposition Y: Companies need owners. Institutional shareholders can and must fill the ownership gap. They probably need to do more.

As shown in **Table 2**, there was a wide dispersion of views on these propositions, but on balance, our workshop participants were clear about the unique role of institutional investors and their importance in fulfilling that role.

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Table 2. For the Competing Propositions X and Y, Which Best Reflects the Group's Own View?

Proposition X	Strongly prefer proposition X to proposition Y	Tend to prefer proposition X to proposition Y	Tend to prefer proposition Y to proposition X	Strongly prefer proposition Y to proposition X	Proposition Y
Stewardship is a nice idea. But institutional shareholders have only limited resources to carry out that function. You can't place too much burden on them.					Companies need owners. Institutional shareholders can and must fill the ownership gap. They probably need to do more.
Institutional shareholders have a role to play; but realistically, it is a limited one. The burden must rest with boards and with others in the governance system: auditors, regulators, media, and so on.					Institutional shareholders are the only group which can hold companies to account. Others play important roles, but investment institutions are a cornerstone and must devote resources to this task.

● Individual Observation —— Workshop Average

Comply or Explain vs. Hard Law Regulation

We asked workshop participants to assess the degree to which regulation at the EU level was helpful in promoting good governance and the extent to which it should adopt a comply-or-explain approach, if it is used. Participants were asked to choose between Proposition X, which suggests a limited role for shareholders, and Proposition Y, which suggests a more central role.

As shown in **Table 3**, they tended to generally be quite positive about a continuing programme of EU intervention, including a comply-or-explain approach, underpinned by rigorous standards.

Table 3. For the Competing Propositions X and Y, Which Best Reflects the Group's Own View?

Proposition X	Strongly prefer proposition X to proposition Y	Tend to prefer proposition X to proposition Y	Tend to prefer proposition Y to proposition X	Strongly prefer proposition Y to proposition X	Proposition Y
Corporate governance is a private affair and should be flexible. We have done enough, and if more standards are required, it can be done at the national level. The EU should be aware of mission creep.					The promise of integrated capital markets, and/or of a European civil economy, is huge. It follows that the EU should continue to find ways to improve and harmonise governance.
If legislators must intervene, it should be on a comply-or-explain basis.					Surely we have learned that comply-or-explain doesn't work.

● Individual Observation —— Workshop Average

In summary, workshop participants recognised the value of further harmonisation of governance standards. They believed institutional investors should, and could, play a central role in creating good governance (although they might need to apply more resources to it). As one would expect, they advocated strongly for shareholder rights. At the same time, they also recognised the importance of other stakeholders and believed that, as fiduciaries, shareholder rights could be used to promote more than just the financial success of a company. For companies to be sustainable, it is critical to establish positive stakeholder

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relations and for companies to pay attention to the social and environmental aspects of their operations.

That might seem a quite positive conclusion that offers space for constructive policy development. But workshop participants were generally those within the institutional investment community who have been given responsibility for corporate governance; their own opinions may not always reflect either the views or the behaviours of the executive management or fund managers of the institutions they represent. To build a holistic and more representative picture of the investment community, we broadened our discussions to include the opinions and the practices of investors more generally. **Table 4** presents the results of how what investors do differs from what investors say they do.

Table 4. For the Competing Propositions X and Y, Which Best Reflects the Group's Own View?

(a) What is the group's own view?
(b) Where the group thinks most investors would position themselves?
(c) What most investors actually do?

Proposition X	Strongly prefer proposition X to proposition Y	Tend to prefer proposition X to proposition Y	Tend to prefer proposition Y to proposition X	Strongly prefer proposition Y to proposition X	Proposition Y
Companies are there to make money. That's why we invest in them. Asking them to do more is a costly burden which is usually against shareholder interests.					Institutional investors are fiduciaries. On behalf of their clients, they should ask companies to reflect broader social norms and obligations. In any case, this rarely hurts profitability.
Shareholders are the owners of companies, and boards should serve them. That's what capitalism means!					There are other stakeholders in company activities. Of course they should have access and influence in company decisions.
Shareholder rights are fundamental. That is true whether or not that leads to companies which create more value.					Companies should be delivering long-term value and be subject to proper financial disciplines. We should be open minded about how that is achieved.
Stewardship is a nice idea. But institutional shareholders have only limited resources to carry out that function. You can't place too much burden on them.					Companies need owners. Institutional shareholders can and must fill the ownership gap. The probably need to do more.
Institutional shareholders have a role to play; but realistically, it is a limited one. The burden must rest with boards and with others in the governance system: auditors, regulators, media, and so on.					Institutional shareholders are the only group which can hold companies to account. Others play important roles, but investment institutions are a cornerstone and must devote resources to this task.
Corporate governance is a private affair and should be flexible. We have done enough, and if more standards are required, it can be done at the national level. The EU should be aware of mission creep.					The promise of integrated capital markets, and/or of a European civil economy, is huge. It follows that the EU should continue to find ways to improve and harmonise governance.
If legislators must intervene, it should be on a comply-or-explain basis.					Surely we have learned that comply-or-explain doesn't work.

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These discussions produced quite different results. When asked how investors actually behave, in the context of the aforementioned competing propositions, workshop participants felt investors often showed little sympathy for the claims of stakeholders. Their perception is that their institutions are somewhat weak in defending shareholder rights and in taking on fiduciary responsibilities. They tended to oppose any extension of the EU's role, and where they did support it, it was on a comply-or-explain basis.

Therefore, in contrast to their own views, our workshop participants believed that the investment industry fell short in its openness to stakeholders, in its willingness to shoulder responsibility, and in its support for development of an EU framework of governance. These results might seem to indicate fairly fallow ground for policy development—particularly with regard to greater clarity from the EU on its expectations for investor stewardship.

There was one further question we asked participants; we asked them to assess what investors think, not just how investors behave. In every case, their assessment of what investors thought was closer to the participants' own opinions and closer to a constructive avenue for policy development. One might speculate that the reason for this outcome is that over the past few years, there has been a growing recognition of the need for institutional involvement in corporate governance. Leading that shift in thinking are those whom the investors have put in charge of governance and who attended our workshops. Their institutions have been slower in moving their thinking and slower yet in changing their practice.

This result might be regarded as positive by those who have framed EU governance policy over the past decades. Investment institutions have devoted resources and appointed staff to oversee governance. These people share a vision of accountable companies, with fiduciary investors accepting stewardship responsibilities that encompass financial and other stakeholder concerns. The investment institutions are beginning to share this perspective but still have much to do to reflect that thinking consistently in their behaviour. Nevertheless, the journey has begun.

VI. An Investor Vision for Europe

The results drawn from three workshops and 30 participants reveal that governance considerations are multifaceted and sometimes complex. As such, reaching a definitive position is prohibitive. However, the results of our workshops do suggest a collective investor vision, which is supportive of stakeholder and other economic or open market concerns. This vision might be articulated as follows:

> As institutional investors, we invest in companies to generate sustainable returns for our clients, typically with a long-term focus. We, therefore, require companies to be responsive to shareholders' need for a financial return in order to fulfil our clients' needs. In that context, and as minority investors, we need the rights of all shareholders to be upheld. If institutional investors are to play a constructive role in the European corporate governance ecosystem, they need to have the ownership rights to exercise their stewardship.
>
> However, shareholder rights do not in any way preclude the rights of other stakeholders. Positive stakeholder relations are key to a company's long-term success; poor stakeholder relations can threaten a company's long-term sustainability. Furthermore, given that we are fiduciaries for millions of savers, we want companies to understand and reflect social norms and obligations as well as support the rights of other stakeholders to have access and influence in company decisions, as appropriate and consistent with our rights as shareholders.
>
> We are open to and would support the EU in helping us find a way to be better stewards in improving the financial, social, and environmental performance of the companies in which we invest but would caution that good governance cannot be regulated and that investors are only part, albeit a central part, of the governance system.

Such an investor vision suggests considerable opportunities for progress. Critically, it suggests that there may be a possibility of a "sweet spot" in the governance mosaic in which the shareholder, stakeholder, and open market perspectives can fit together in relative harmony. This harmony is at least the aspirational goal.

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Policy Considerations

For such developments to be successful, a number of important practical considerations need to be kept in mind. The first relates to policy choice. There are certain issues in which shareholders will welcome the promotion of measures that might have been thought to be ones promoted by those who took a stakeholder or an open market perspective. There are others that they will firmly oppose. Our workshop participants had little objection to improving diversity in the boardroom—for example, the promotion of women as directors—or considering stakeholders in company decision making. For example, our participants seemed relatively confident that banks, as systemically important financial institutions, might require different governance structures than most quoted companies. However, there would be considerable opposition to the encouragement of structures that would weaken the already fragile influence that institutional shareholders command over companies. So, for example, there was strong opposition to the Florange Act in France, which aimed to give additional powers to long-term shareholders but has the collateral effect of entrenching dominant shareholding blocks.

From a policy perspective, Panel B of Figure 1 should inform the policies that might be supported from all the different perspectives. In **Table 5**, we have tried to identify those policies that are likely to create consensus (green) and those that might generate conflict (purple).

Table 5. Governance Proposals and Policy Perspectives

	Investor Perspective	Stakeholder Perspective	Open Market Perspective
Fix the plumbing of proxy voting	Neutral	Neutral	Neutral
Company disclosure on ESG issues	Supportive	Highly Supportive	Supportive subject to practicality?
Disclosure harmonisation	Highly Supportive	Supportive	Neutral
Shareholder identification	Supportive?	Highly Supportive	Supportive?
Country-by-country disclosures	Neutral	Highly Supportive	Neutral
Board diversity	Supportive	Highly Supportive	Potentially Negative
Accountability and independence of directors	Highly Supportive	Supportive	Potentially Negative
Proxy access/ shareholder nomination of director candidates	Highly Supportive	Neutral	Potentially Negative
Shareholder engagement with company directors	Highly Supportive	Neutral	Neutral
Related-party transactions	Highly Supportive	Neutral	Potentially Negative
Differential ownership rights	Negative	Neutral	Potentially Supportive
Remuneration	Supportive	Supportive	Potentially Negative

A second consideration for policymakers is to recognise that the investment industry does not have a single view of how policy might progress. In particular, those who are charged with implementing good stewardship within investment firms see considerable scope for reform within their own industry. This view might suggest that policymakers need to understand that if they are to be successful, they need to not only understand the limitations of the investment industry in policing good corporate governance but also understand that the industry itself needs help to overcome these limitations. For example, a considerable positive effect could be gained if the ultimate clients of investment and

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insurance companies were alerted to the need to demand a better response on these issues or if EU leaders asked for better practice from the heads of investment companies. Note that both of these actions do not require legislative action. Indeed, many of the requests made by workshop participants were not for new rights and protections but simply for the EU to be clear that its purpose is to promote greater fiduciary responsibility on the part of institutional investors and to support a governance ecosystem to realise that objective.

Third, as in the sphere of political governance, in corporate governance there is no one measure that will address all issues. Rather, there is a need to build a consensus on the purpose of governance and the proper role of many players in improving it. There is not a single end point but rather an ecosystem of checks and balances that will encourage companies to behave in a way that is in the interest of both the private and the public sectors.

In short, just as in the political sphere, corporate governance works when all the players recognise their respective rights and responsibilities. Governance may be underpinned by the law, but it is conducted through a common understanding of roles and responsibilities.

What should be apparent from this discussion is that good governance cannot be achieved by legislative fiat alone. It is for that reason that comply-or-explain has proved helpful. To use a metaphor, if Europe is aiming to construct a healthy corporate governance ecosystem, legislators might usefully consider their role not as architects of the system, who can specify outcomes, but as gardeners who can help tend and improve processes, which in large measure will be beyond their control.

The danger now is that, as the current programme of governance reform comes to an end, discussion about the nature of the corporations we seek will be overlooked. Yet, corporations and corporate governance touch on every aspect of economic life and cannot be divorced from other EU legislation and initiatives. For example, the EU has recently consulted on measures for encouraging long-term investment; it is developing proposals to clarify fiduciary duties of financial intermediaries, encouraging greater integration of ESG, and proposing the CMU. It is difficult to see how such measures can be achieved properly without touching on corporate governance matters. However, from our interviews and workshops, we have concluded that there is no clear vision of what might guide any such intervention. Therefore, the danger is that well-intentioned directives aimed at one issue may have collateral, and potentially damaging, effects on the corporate governance agenda.[24]

[24]If nothing else, there is scope to ensure appropriate impact assessments for governance legislation, which will include pre- and post-implementation assessments.

Intervention of this nature is not without precedent. In the aftermath of the financial crisis, regulators placed great emphasis on investment liquidity as a way of mitigating risk, but this focus had the unintended consequence of limiting long-term illiquid investments. Is there the danger that similarly well-intentioned directives aimed at economic goals may have a negative impact on governance?

From a more positive perspective, the fact that the next wave of corporate governance thinking in Europe has not been clearly framed presents an opportunity for a refreshed agenda about the frontiers in corporate governance in Europe that are building towards 2020 and beyond. Our work suggests that there are positive areas to be explored but that these will require action—not just by European political institutions, but also by the investment industry, by company boards, and by all others who are part of the corporate governance ecosystem.

To this end, we have laid out a series of action memoranda in Section VII directed to all relevant stakeholders in the governance ecosystem: policymakers, institutional investors, European companies, and civil society.

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VII. Action Memoranda

In considering the future of corporate governance in Europe, it is important to acknowledge that good governance cannot be brought about by regulation alone. Rather, like political governance, it is an evolving process, involving regulators, investors, companies, and others. With a view towards a vision of European corporate governance in which investors can function effectively, we need to take into consideration the specific roles of those who form part of the wider corporate governance ecosystem: institutional investors, the European Commission, the European Parliament, European companies, and civil society. We have sought to identify practical action steps these individual groups can take to both progress the governance debate and build mutual understanding of differing perspectives, all with a view towards establishing a sustainable and constructive equilibrium among the different goals of governance.

European Commission

Although institutional investors will focus on the governance agenda through their lens of promoting shareholder rights to achieve sustainable long-term returns for clients and beneficiaries, the European Commission's primary focus on governance is as a means to achieve positive economic and social outcomes, which includes focussing on the upside of economic growth, enhanced market efficiency and competitiveness, and better financing for key sectors, such as for SMEs. It might also include focus on transparency and best practice in responding to environmental challenges or to the need for equal opportunities. Furthermore, there will be a focus on avoiding the downside, as we see in the case of banking, for which the aim is to promote financial system stability.

Memo to the European Commission

To: Commissioner Věra Jourová at DG JUST, Commissioner Valdis Dombrovskis at DG FISMA, and Vice President Jyrki Katainen

From: CFA Institute

Subject: The EU and the Future of Corporate Governance in Europe

We congratulate DG JUST on assuming responsibility for corporate governance issues, and we recognise the critical role played by DG FISMA in the financial sector. This topic is hugely important. As James Wolfensohn, former head of the World Bank, reminded us, "the governance of the corporation is now as important in the world economy as the government of countries."[25]

For about 15 years, the EU has pursued a constructive programme aimed at creating more open and transparent companies with competent and accountable boards and ultimately overseen by responsible shareowners (discussed in Section II of our report).

This slow and careful reform has built consensus and has helped encourage better practice. However, we suggest that the reform process is not yet over. Furthermore, there will be pressure to use corporate governance as a way to address other issues. Some of these issues will be quite legitimate, and investors will be happy to accommodate them; other issues could undermine what has already been achieved. Our suggestions for how the momentum of the reform process can be maintained and how policy can develop a broad positive consensus are discussed in the following.

Completing the Reform Process

In the field of political governance, we are used to the concept that "the price of liberty is eternal vigilance." The same is true in corporate governance; it is a process, not a product.

Investors are generally not looking to the Commission for much in the way of new regulation; indeed, there is a wariness of new regulation. However, they note that, with SRD II nearly complete, there is a lack of direction in EU corporate governance. Current initiatives are disparate, and minority shareholders remain concerned about an imbalance in ownership rights with controlling shareholders and the risks this imbalance brings to company accountability.

One simple remedy would be for the EU to be more forthcoming in expressing the type of open, competently managed, and accountable corporations it wishes to promote and the responsible stewardship it expects of investors.

For example, the Commission could promote investor engagement with companies. Although investor engagement is a normal practice in such markets as the Netherlands and the United Kingdom, pockets of resistance remain in many European markets, and in

[25]See Wolfensohn (1998, p. 38).

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most markets, engagement with directors is rare. The Commission may want to consider a guidance statement for company boards and for institutional investors articulating its stewardship expectations.

In doing so, the Commission will note that, by its own evaluation, institutional investors fall short of what is needed for an effective and accountable system to work. In stepping into this breach, there is a concern that regulators may not fully appreciate the complexities that many large investors face. Rather than embark on many new initiatives, investors would welcome encouragement to carry out their role—especially in promoting interest in stewardship by clients or asset owners. They would welcome a focus on improving the existing mechanisms to achieve accountability—such as cross-border voting—that are currently, at best, clumsy and difficult to use. There are a number of proposals aimed at making the system work that we suggest in Section III of our report.

In doing so, we fully recognise that there are other calls for change in the corporate governance system, particularly for social and environmental good practice. Often, these calls for change are associated with the stakeholder's point of view. We believe that progress with the current models of governance will be capable of addressing many of these. As investors, we are fiduciaries for the savings of hundreds of millions of people, and we recognise the need for companies to represent broad societal interests. Therefore, there is considerable scope for the Commission to continue to make progress with ongoing governance issues that carry general support (or at least limited controversy) among proponents of the shareholder, open market, and stakeholder perspectives—as noted in Table 5 in Section VI.

In this context, the Commission should also seek to encourage strong monitoring mechanisms in individual member states to ensure that companies either adhere to governance code requirements or provide a credible explanation. Different monitoring systems exist in some European markets, and the Commission might be agnostic as to how a monitoring system is organised and championed, but it should at least seek to ensure that individual states have an appropriate mechanism to give substance to soft law.

Governance is exercised through the capital markets. Yet, the Capital Markets Union initiative pays little attention to it, possibly because it is based in DG FISMA. The Commission may want to consider how further governance policy work might be integrated with the CMU to address investor concerns about their rights in European companies with controlling shareholders. In this context, we emphasise the importance of ensuring coherence and coordinated thinking between the governance mandates of DG JUST and DG FISMA.

Some Difficult Issues

In the previous section, we outlined issues for which we think a broad consensus can, with care, be readily reached. There are, however, one or two areas in which tough decisions lie ahead. The toughest issues arguably are the ones involving the rights of minority investors when there is a controlling shareholder. This issue is particularly key in continental Europe with the predominance of SMEs.

In this regard, the Commission will continue to face difficult and conflicting pressures, particularly on key minority rights issues relating to board accountability, proxy access, votes on RPTs, and so on. These investor concerns will not go away after SRD II is concluded, so ongoing policy work may be needed.

We note that there is a legitimate criticism that the enforcement of minimum governance standards can discourage companies from seeking to raise financing in public markets. Such concerns do need to be addressed. However, the evidence suggests that, in most sectors, accountability to shareholders creates stronger companies that are more productive and focussed, including in areas that are critical for the future of the European economy, such as research and development.

With the transfer of governance to DG JUST, there might be the danger that momentum will be lost and the consensus for progress will dissipate. With Wolfensohn's words in our ears, we trust that this will not happen, that this critical agenda will not be overlooked, and that our report will help guide a productive future policy agenda.

Institutional Investors

Good corporate governance is a prerequisite for institutional investors—both asset owners and asset managers—to perform their function well. Their function is to deliver sustainable, long-term returns to their clients to underpin pension liabilities and other contingencies. But institutional investors are not just users of the system; they also have a critical role to play in making comply-or-explain systems of corporate governance effective in Europe. This role means that they need to press for the rights to allow them to fulfil their fiduciary duties as stewards. It also requires them to exercise these rights responsibly. In both regards, our study has revealed gaps.

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Memo to Institutional Investors

To: CEOs and chief investment officers of Europe's leading institutional investors

From: CFA Institute

Subject: Rights and Responsibilities of Investors in Europe

Over the past two decades, much has been done by institutional investors to promote good governance. This work has been assisted by the European Union, which has championed a process to create a framework that encourages competent and responsible boards that are accountable to shareholders.

However, this process of reform is now at a crossroads. There are a considerable number of legitimate groups, including from within your own industry, who question whether the current model of governance makes sense and whether institutional investors have the will and resources to fulfil their responsibilities. We believe that both these questions can be answered positively but only if institutional investors redouble their efforts.

Given the new provisions in SRD II relating to investor responsibilities in promoting a healthy governance system, investors should regularly review their own internal governance standards to ensure appropriate tone and commitment from top management as well as clear and realistic expectations with regard to stewardship responsibilities. This review should begin with an assessment of the investor's commitment to stewardship and then link this commitment to business models and resources needed to make successful fiduciary stewardship a reality in terms of monitoring, voting, and engagement.[26] In this regard, our workshop findings are sobering. Participants from within the industry believe that there is a gap between the rhetoric and the actions of institutional investors with regard to good governance (see Section VI of the report).

Asset owners and asset managers typically have different, but complementary, roles to play in establishing responsible institutional investment practices. However, both have fiduciary responsibilities to their end beneficiaries.

[26]Guidance on fiduciary stewardship already exists in the form of stewardship codes in many markets. For markets without stewardship codes, the ICGN Global Governance Principles and the ICGN Global Stewardship Principles (to be launched in mid-2016) provide a global framework to frame good practice in stewardship and related disclosures. See www.icgn.org/policy.

- **Asset owners.** Particularly for asset owners with long-term strategies, asset owners and their trustees should set the tone and establish expectations for investor stewardship in investment mandates with asset managers. Even if asset owners do not actively undertake specific stewardship activities themselves, they should be accountable for ensuring that these activities form a standard part of an asset owner/asset manager relationship. If fiduciary duties, including stewardship and long-term performance considerations, are not included in investment management agreements, then the asset manager may feel it has little, if any, obligation to take on board stewardship requirements on behalf of asset owners. Asset owners should also communicate their stewardship standards to their end beneficiaries.

- **Asset managers.** Because asset managers often do much of the "heavy lifting" of stewardship on behalf of their asset owner clients, they may face the greatest challenge in reconciling business models, conflicts of interest, and required stewardship capabilities and resources. Tone is also critical here. If the top managers of asset management firms do not themselves embrace the ambitions of investor stewardship in Europe, then there is a real risk that any stewardship activities might be a hollow compliance exercise.

Institutional investors are likely to be challenged about their legitimacy and their effectiveness in policing good governance. Such criticism often comes from those who believe that companies should be responsive to broader stakeholder interests. We urge institutional investors to be open minded about this critique. Our workshop suggests that there is considerable overlap between these positions in **promoting sustainable long-term company success and value creation**, particularly in the face of growing concerns about market short-termism.

Institutional investors seek to serve their beneficiaries—in aggregate, millions of people who are usually saving for the long term. Of course, these people need a financial return, but not one that is created in a way that is indifferent to social and environmental costs, which are typically the issues stakeholder advocates are concerned about. Therefore, we encourage institutional investors to do the following:

- **Broaden their perspectives on risk, including consideration of long-term and ESG factors, and the effect of these factors on their beneficiaries.** Although already happening to a degree, the Capital Markets Union and the Long-Term Financing initiatives are encouraging further work in this area—even if these initiatives do not themselves focus on corporate governance or listed equities. Investors should be prompted to identify key stakeholder and ESG factors that pose long-term valuation concerns for investors—both in individual companies and across the markets more generally. Civil society groups in particular—with subject matter expertise in specific stakeholder issues, such as environmental issues, anticorruption, human rights, and tax

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policies—are positioned to inform investors on broader ESG risks facing companies. A broader outreach to these groups makes sense not only from a policy point of view but also from an investment perspective.

- **Enhance transparency to allow for effective monitoring.** The growing emphasis on stewardship codes and on investor disclosure standards in SRD II call for investors to provide robust disclosures to demonstrate their stewardship activities and commitment to stewardship. Although there may be scope for the European Commission to be clearer about its own expectations of investors and to consider how investor disclosure might best be monitored and enforced, investors should appreciate the importance of demonstrating their commitments in terms of actions taken. In the first instance, transparency should be focussed on the institutional investor's end client: an asset owner or an end beneficiary. But ultimately, there is scope for public disclosures as well, as provided for in SRD II, that will allow policymakers and other observers to monitor how effectively investors are exercising their ownership rights and engaging in responsible fiduciary practices.

Ongoing Challenges

Minority shareholder rights, particularly in the context of controlled companies, are arguably the most pressing practical concern of institutional investors investing in European equities. Investors will find considerable opposition on this issue from some in the corporate community, and their failure to address stewardship issues will leave them exposed.

To be clear, the direction of European policy over the past 15 years has been quite pro-investor. Investors should make sure that those rights that have been agreed on in principle are possible to exercise in practice. Investors should continue to work with others to fix the "plumbing" of cross-border proxy voting to ensure that shareholders are able to vote in an informed way and that all legitimately owned and cast votes by shareholders are formally counted and ultimately confirmable to the voting shareholder. This issue was identified in the 2002 High Level Group of Company Law Experts' report on governance and remains problematic, in part because of differing legal requirements in member states and a lack of clarity among those involved with the process (investors, custodians, companies) about who should shoulder (and potentially pay for) changes to facilitate required reforms.

However, there are other critical changes needed to ensure minority shareholder protection. These include promoting better board accountability to minority shareholders through more robust independence standards, a greater role in hiring and firing board members, and stronger board diversity; continuing to press for rights relating to material related-party

transaction votes in the event that SRD II is watered down in this area; and continuing to challenge attempts to establish differential ownership rights and dual class share structures, not only in individual countries but even more importantly in systemic contexts—such as the imposition of the Florange Act in France.

But the success of institutional investors in achieving these goals—indeed, their success in achieving the continuing promotion of shareholder rights—will depend on the ability to exercise those rights responsibly. As our report shows, there is a gap in this regard; investors say they want rights, but in asserting these claims, they can sometimes be indifferent to rights requested by others, such as stakeholders, even when these are not in conflict with investor positions. More critically, in practice, investors often fail properly to exercise or even defend the rights they claim.

A more open discussion is needed. How, for example, can investment be channelled to smaller companies? How can the requirements for public listing and investment be made less onerous without undermining governance standards? These are pressing, practical questions. And unless institutional investors are able to address these questions while practicing what they preach with regard to good governance, they will find others willing to fill the gap.

Were this to happen, it would be a terrible wasted opportunity, not only for the institutional investors but also for the hundreds of millions of beneficiaries who depend on them to exercise their rights appropriately.

European Parliament

The European Parliament generally shares with the Commission the awareness of the need for corporate governance reform to promote European economic growth and development and to preserve financial system stability. But in the European corporate governance debate, the Parliament—notwithstanding its multiparty constituency—has also assumed a voice in pressing for stakeholder rights, particularly for employees, and for corporate governance to support a wide range of social objectives. Parliament representatives have shown positive willingness to share and debate their views on governance, but there also appears to be a degree of mistrust that an institutional investor agenda can truly be compatible with a long-term approach to investment and the broader social concerns of stakeholders.

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Memo to the European Parliament

To: Martin Schulz, member of the European Parliament (MEP) and president of the European Parliament; Roberto Gualtieri, MEP and chair of the ECON Committee; and Pavel Svoboda, MEP and chair of the JURI Committee

From: CFA Institute

Subject: Your Voice in European Corporate Governance

The European Parliament has been an important voice in corporate governance. The topic is, of course, one that historically has created considerable controversy about who controls the ways and means of production. Such issues are naturally a part of parliamentary debate, in which many different views are represented. But there is also a consensus that all parties want companies that are competently run, responsible, and accountable.

We believe there is every opportunity to build on that consensus. For the past 15 years, the EU has, in particular, favoured accountability mechanisms that focus on the shareholder. There is much to be said for this approach, as discussed in Section VI of our report, not the least of which that it is consistent with the evidence of what produces strong companies. But it does raise two important questions. First, how are other stakeholders to be represented, and second, how can we encourage competent and willing shareholders who will fulfil their roles?

Focussing first on stakeholder and employee interests, the Parliament should remember that in many cases, **institutional investors ultimately represent the interests of employees and normal citizens** in terms of managing their long-term pension assets. In this context, the European citizen who may be a stakeholder can also be an indirect participant in the corporate governance process through membership in company and government pension plans. So, it is not a simple question of shareholders versus stakeholders. In aggregate, the stakeholders that Parliament seeks to protect are often the same people who are dependent on the investment practices of institutional investors to ensure that their long-term savings are responsibly managed. Common ground does exist here. The question then becomes, How do we create institutions that will oversee successful and accountable companies?

In that context, our report suggests that although institutional investors may be capable of delivering better corporate governance oversight, today they fall short of their aspirations (see Section VI), notwithstanding considerable improvements in stewardship in recent years. We encourage the Parliament to understand the practical and commercial constraints on investors and to encourage them to better practice. We also suggest that there are many areas

in which stakeholder issues converge with the interests of those whom institutional investors are there to serve. These include such issues as integrating ESG factors in the investment process, seeking to ensure appropriate and fair remuneration of company executives, encouraging board accountability and diversity, and promoting long-term investment horizons. Although it may not support investor concerns on every issue, the Parliament will find many issues on which there will be a broad consensus, and we encourage dialogue to ensure adequate lines of communication and to build mutual understanding.

We hope that this report, and some of the recommendations we make, will be helpful in that process.

European Companies

The good management of companies is a key objective in the European governance ecosystem—and the primary subject of corporate governance codes. As our report has identified, there are a number of issues in which the interests of company management, or controlling shareholder interests, may seem to conflict with institutional investors; and we noted this particularly in the area of minority shareholder rights in controlled companies. Differing views exist among companies and investors on certain shareholder rights identified in our report, including views on board independence and accountability, shareholder director nomination, and votes on related-party transactions. However, a good system of governance should be capable of reconciling and minimising many of these difficulties.

Memo to European Companies

To: Company chairs and chief executives of listed European companies

From: CFA Institute

Subject: Your Role in European Corporate Governance

To many companies, the regulation of corporate governance may seem like yet another costly, and perhaps unnecessary, compliance exercise. But corporate governance is at the heart of the financial system; it is the way in which institutional investors can be assured that when they invest the savings of the millions of people whose wealth they manage, the companies

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whose shares they have purchased will be run with integrity. The fact that in Europe we have developed a system that is broadly trustworthy is a legal and social innovation of huge benefit to the economy.

Of course, institutional investors are themselves part of the governance system in the sense that they manage other people's money, not their own. And, by their own admission (see Section VI of our report), their behaviour can fall short of what they would like to achieve, and their behaviour can sometimes appear to focus unduly on short-term profits. But that is not the intent.

Equally, governance can often be seen as overly rigid. Again, that is not the intent, either of investors or of regulators. Governance in Europe rests on a regime of comply-or-explain, which is a system we must make work. Because if we do not, the alternative is rigid rules, which will benefit no one. So, between investors and companies we need to **make comply-or-explain credible**. Companies should either **comply with the principles and best practice provisions of an established code or provide a thoughtful and not generic explanation for deviation from the code**. Companies should encourage better monitoring in this domain. Properly undertaken, investor stewardship should not be a burden; rather, it should contribute to the better management of companies and the broader integrity of European capital markets.

So, we encourage companies to **build a constructive attitude towards engagement with investors** to establish mutual understanding and long-term relationships. Shareholder engagement with board directors remains a concern, particularly on the continent, and as noted in Section IV, it is a specific area in which improvements can occur. Companies will not agree with every investor concern, but they should be in a position to both understand investor views and explain their own positions on key issues, including shareholder rights, board effectiveness, and remuneration.[27]

There will of course be issues on which minority and controlling shareholders may have different interests. But these differences do not need to create an impasse. We note, for example, that in Italy and in Sweden, particular governance systems exist to help protect minority shareholders and to allow capital to flow for the benefit of all shareholders. We hope that in opening up their boards in this fashion, companies are better run. This discussion will be ongoing, but we trust it is one that will be informed by the commonality of interest between institutional investors and companies wishing to raise capital for the long term.

[27]In this regard, companies will have the support of most mainstream institutional investors in establishing a better shareholder identification process.

Civil Society

Memo to Civil Society

To: Civil society organisations with an interest in European corporate governance

From: CFA Institute

Subject: Your Role in European Corporate Governance

As institutional investors, we recognise the role played by civil society groups in the corporate governance debate. You have a potentially important role to play, particularly those groups that represent stakeholder interests of relevance to companies, investors, and corporate governance.

In many cases, civil society groups have developed important subject matter expertise in such areas as environmental issues, business ethics, anticorruption, and human rights. Indeed, their expertise in these areas is often more developed than that of institutional investors, and they are thus often better equipped to play the role of the watchdog in terms of monitoring companies for poor stakeholder practices, which can lead to heightened risks for both companies and investors over time. As investor awareness of ESG factors and other non-traditional business risks continues to build, civil society groups can serve a very useful role in monitoring companies to highlight potential concerns and risks in ways that benefit both stakeholders and investors.

So, we conclude that investors should learn to regard civil society as a potential partner in good governance, just as they are critical in political governance. But civil society groups will be more constructive and more influential to the extent that they understand the roles that institutional investors can and cannot play. First, civil society groups should recognise that the primary and proper role of fiduciary investors is to look after the interests of their clients—in particular, their financial interests. As discussed in Section VI, this role leaves considerable scope for discussion of other stakeholder and social issues, but this fundamental fiduciary duty of care cannot be ignored. Second, as with the political system, there remains scope for improvement in governance of companies and the fiduciary role played by investors.

As investors, we have laid out a vision for European corporate governance. It is certainly not perfect, but we believe it is both aspirational and achievable. Overseen by committed

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fiduciary investors and undertaken on behalf of the millions who entrust their savings to those investors, it may be, to borrow phrasing from Winston Churchill, the worst form of governance except for all those other forms that have been tried from time to time.

Appendix

A. Timeline of Key Policy Developments

- **2002 High Level Group of Company Law Experts Report**

  Establishes a framework for modernising European law and corporate governance on issues that include improved corporate disclosures, shareholder rights and voting, board effectiveness, remuneration, audit quality, and the responsibilities of institutional investors.

- **2003 Corporate Governance Action Plan**

  Avoids the adoption of a Europe-wide code; focus on corporate governance disclosure, strengthening shareholders' rights, and modernising the board of directors.

- **2010 Green Paper on Audit Policy: Lessons from the Crisis**

  Focus on the role and scope of auditors, including appointment, remuneration, and mandatory rotation.

- **2010 Green Paper on Corporate Governance in Financial Institutions**

  Focus on systemic risk, board effectiveness, risk management, effectiveness of comply-or-explain, shareholders' roles, and remuneration.

- **2011 Green Paper on Corporate Governance in Listed Companies**

  Focus on board effectiveness (composition, diversity, commitment, and board evaluations), remuneration, shareholder rights and responsibilities, short-termism in the capital market, how to make comply-or-explain work, and employee ownership.

- **2012 Corporate Governance Action Plan**

  A 14-point plan focussing on bolstering corporate transparency, engaging shareholders, and law harmonisation.

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- **2014 Proposed Revisions to the Shareholder Rights Directive**

  Multifaceted review seeking to address the lack of adequate corporate transparency and insufficient engagement of shareholders. Key proposed provisions relate to shareholder identification, facilitation of voting rights, investor transparency regarding voting and engagement, proxy adviser transparency, say-on-pay vote, and shareholder vote on RPTs.

B. Timeline of Key Regulatory Outputs

- **2004 Directive on Transparency Requirements for Listed Issuers**

  Harmonises transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

- **2004 Directive on Takeover Bids**

  Focus on minimum standards for takeover bids and protecting minority shareholders and employees.

- **2004 Recommendation on Remuneration**

  Focus on long-term, performance-based pay; public disclosure; remuneration committee; and shareholders' roles.

- **2005 Recommendation on Boards**

  Focus on board independence and committees.

- **2005 Amendments on 4th and 7th Company Law Directives**

  Provides updated guidance for annual corporate governance statements, disclosure on risk management, and material RPTs.

- **2005 10th Company Law Directive on Cross-Border Mergers**

  Focus on facilitating cross-border mergers of limited liability companies in the European Union.

- **2006 Directive on Statutory Audit of Annual and Consolidated Accounts**

  Focus on auditor quality and the audit process, including auditor appointment and audit committees.

- **2007 Shareholder Rights Directive**

  Focus on access to annual general meeting information and proxy voting.

- **2009 Recommendation on Remuneration**

  Builds from the 2005 Recommendations and provides greater guidance on the balance between long-term and short-term criteria, deferred pay, minimum vesting periods, and executive share retention, as well as the governance of remuneration.

- **2012 Proposed Directive on Improving Gender Balance on Boards**

  Sets an objective of a 40% presence of the under-represented gender on boards.

- **2013 Accounting Directive**

  Covers governance-related provisions, including the requirement for a corporate governance statement that includes comply-or-explain relative to a given code, prudential reporting, audit reporting, and country-by-country reporting (extractive companies).

- **2013 Transparency Directive**

  Reduces reporting burden for SMEs, abolishes quarterly reporting, and requires disclosure of major holdings.

- **2013 Capital Requirements Directive (CRD IV)**

  Prescriptive governance measures focussing on remuneration, including pay caps, for financial institutions.

- **2014 Accounting Directive Amendment on Disclosures**

  Focus on nonfinancial statement disclosures, including information relating to ESG issues, sustainability, and disclosure of diversity policies.

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- **2014 Statutory Audit of Public-Interest Entities (Regulation 537)**

  Addresses nonaudit fees, audit reporting, auditor independence, and a 10–20 year mandatory rotation.

- **2014 Proposed Revisions to Shareholder Rights Directive**

  Key proposed provisions relate to shareholder identification, facilitation of voting rights, investor transparency regarding voting and engagement, proxy adviser transparency, say-on-pay vote, shareholder vote on RPTs, and country-by-country reporting.

C. Timeline of Key Financial Market Initiatives

The following are policies that focus on protecting consumers, attracting foreign investment, and providing more efficient funding to companies to stimulate employment and growth. There is a growing emphasis on infrastructure and SMEs and a limited focus on corporate governance.

- **1999 Financial Services Action Plan (FSAP)**

  Focusses on financial integration and harmonisation; little direct focus on corporate governance.

- **2003 Prospectus Directive**

  Establishes rules about the prospectus that EU companies are required to publish when they issue securities.

- **2004 Markets in Financial Instruments Directive (MiFID)**

  Focusses on harmonising consumer protections, particularly with regard to financial and investment services provided by investment firms and banks.

- **2009 Solvency II Framework Directive**

  Focusses on risk-based prudential and solvency rules for insurers.

- **2011 Directive on Alternative Investment Fund Managers**

  Focusses on such issues as liquidity, leverage, reporting, risk management, and conflicts of interest for alternative funds, including hedge funds.

- **2012 Communication on Banking Union**

  Focusses on a "single rulebook," including stronger prudential requirements for banks, improved depositor protection, and rules for managing failing banks.

- **2014 Long-Term Financing Communication**

  Focusses on funding for long-term infrastructure initiatives and providing additional sources of financing for companies, particularly for SMEs. Consultation on investor use of ESG information linked to long-term investment (2015).

- **2015 Capital Markets Union Action Plan**

  Focusses on broader financing alternatives to fund SMEs, including the use of bonds and other fixed-income instruments to provide financing to corporations and green infrastructure, as well as to reinvigorate the practice of securitisation more generally.

- **2015 Review of the Prospectus Directive**

  Focusses on simplifying and limiting prospectus requirements, especially for SMEs, and on simplifying risk disclosure for retail investors.

D. Workshop Participants and Background Meetings

Facilitators

George Dallas, Policy Director, International Corporate Governance Network

David Pitt-Watson, Executive Fellow, London Business School

CFA Institute Representatives

Bob Dannhauser, CFA, Head, Global Private Wealth Management, CFA Institute

Maiju Hamunen, Analyst, Capital Markets Policy, CFA Institute

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Josina Kamerling, Head, Regulatory Outreach EMEA, CFA Institute

Matt Orsagh, CFA, Director, Capital Markets Policy, CFA Institute

Rhodri G. Preece, CFA, Head, Capital Markets Policy EMEA, CFA Institute

Participants

Rients Abma, Executive Director, Eumedion, Netherlands

Marco Becht, Goldschmidt Professor of Corporate Governance, Solvay Brussels School for Economics and Management, and Executive Director, European Corporate Governance Institute, Belgium

Jean-François Bouilly, CFA, Independent Adviser and Board Member, CFA Society France, France

Ian Burger, Head of Corporate Governance, Newton Investment Management, United Kingdom

Frank Curtiss, Head of Corporate Governance, RPMI Railpen, United Kingdom

Jean-Philippe Desmartin, Head of ESG Research, Oddo Securities, France

Natacha Dimitrijevic, Associate Director, Hermes Investment Management, United Kingdom

Paul Emerton, Head of UK Stewardship and Governance, Old Mutual Global Investors, United Kingdom

Mike Everett, Governance & Stewardship Director, Standard Life, United Kingdom

Gerard Fehrenbach, Senior Adviser, Responsible Investment, PGGM, Netherlands

Bram Hendriks, Senior Corporate Governance Officer, NN Investment Partners, Netherlands

Anne-Marie Jourdan, Chief Legal Officer and Public Relations, Fonds de réserve pour les retraites, France

Alexander Juschus, General Manager, IVOX Glass Lewis, Germany

Athanasia Karananou, Senior Manager, Governance Issues, Principles for Responsible Investment, United Kingdom

Niels Lemmers, Legal and Public Affairs Director, Dutch Investors' Association VEB, and Director, European Investors' Association IVZW, Netherlands

Pierre-Henri Leroy, President, Proxinvest, France

Massimo Menchini, Director of Institutional Relations and Corporate Governance, Assogestioni, Italy

Flavia Micilotta, Executive Director, Eurosif, Belgium

Peter Montagnon, Associate Director, Institute of Business Ethics, United Kingdom

Guillaume Prache, Managing Director, Better Finance (European Federation of Investors and Financial Services Users), Belgium

Richard Schreuder, CFA, Senior Portfolio Manager, Saemor Capital, Netherlands

David Shammai, Senior Corporate Governance Specialist, APG, Netherlands

Anita Skipper, Corporate Governance Adviser, Aviva Investors, United Kingdom

Susan Spinner, CFA, Managing Director, CFA Society Germany, Germany

Daniel Summerfield, Co-Head of Responsible Investment, Universities Superannuation Scheme, United Kingdom

Eugenia Unanyants-Jackson, Director, Senior Governance Specialist and ESG Analyst, Allianz Global Investors, United Kingdom

Nicolas Véron, Senior Fellow, Bruegel, Belgium

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Paolo Volpin, Professor of Finance and Head of the Faculty of Finance, Cass Business School, United Kingdom

Trelawny Williams, Global Head of Corporate Finance, Fidelity International, United Kingdom

Simon Wong, Independent Adviser and Visiting Fellow, London School of Economics, United Kingdom

Background Meetings

European Commission

European Parliament

European Corporate Governance Institute

European Securities and Markets Authority

OECD

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THE AMERICAS
(800) 247-8132 PHONE (USA and Canada)
+1 (434) 951-5499 PHONE
+1 (434) 951-5262 FAX

915 East High Street
Charlottesville, VA 22902
USA

477 Madison Avenue
21st Floor
New York, NY 10022
USA

ASIA PACIFIC
+852 2868 2700 PHONE
+852 8228 8820 INFO HOTLINE
+852 2868 9912 FAX

23/F, Man Yee Building
68 Des Voeux Road
Central, Hong Kong SAR

Si Wei Beijing Enterprise Management Consulting Company Limited
Unit 7, Level 12, Office Tower C1, The Towers, Oriental Plaza
No 1 East Chang An Avenue, Dong Cheng District
Beijing, 100738, China

CFA Institute India Private Limited
Naman Centre, Unit No. 103
1st Floor, Bandra-Kurla Complex, G Block, Bandra (East)
Mumbai 400 051, India

EUROPE, MIDDLE EAST, AND AFRICA
+44 (0) 20 7330 9500 PHONE
+44 (0) 20 7330 9501 FAX

131 Finsbury Pavement
7th Floor
London EC2A 1NT
United Kingdom

Rue du Champ de Mars, 23
1050 Brussels, Belgium

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CFA Institute

www.cfainstitute.org
info@cfainstitute.org