Observations of the *Fondation pour le droit continental* on the Proposal for the Revision of the Shareholders Rights Directive

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In the wake of a first general report on the governance of listed companies, which was sent to the European Commission in September 2013, the *Fondation pour le droit continental* wished to present some observations on the Proposal for a Directive by the Parliament and the Council on shareholders' rights of 9 April 2014 which modifies the Directive 2007/36/EC and the directive 2013/34/EU. This Proposal for a Directive is particularly rich and recommends major changes in several areas. The *Fondation* has identified 3 themes which appear to be particularly sensitive at the present time: the *say on pay*, transactions between related parties and the shareholders' commitment.

I. The *say on pay*.

The purpose of Articles 9a and 9b that the proposal intends to add to the text of the directive is to strengthen the shareholders right of control by generalising the *say on pay* in the form of an approval

- by a binding vote of a "friendly" (sic) presentation of the remuneration policy for directors at least every three years comprising the maximum amounts, the proportion of the fixed and variable components, the ratio of the average remuneration of directors to employees, the criteria for variable remuneration regarding the company's interests and long-term viability, and the "clauses of the contracts" of directors ;
- an annual report on the application of this policy including a possible *claw-back* for bonuses and information on the process for fixing remuneration and the role played by remuneration committees.

This proposal, which more or less reproduces the new British legislation (but which would apply to all listed companies and not only to the largest), is based on notions which are specific to it and which are not directly transposable in France or any other Continental law countries.

We shall endeavour to show that this new proposal is out of step with current legislations, because it is not general enough to respect the deep rooted structure of certain laws. This applies to France, both with regards to the way governance is organised as well as the inadequate concepts used by the proposed directive.

A. The difficulties connected with the legal organisation of governance in French public limited companies: the principle of the competence of the board of directors

The principle is that boards of directors are exclusively competent for remuneration, although this principle has been subject to 2 significant exceptions in recent years.

1/ The principle.

Articles 9 (a) and 9 (b) of the draft directive only refer to directors. However in France, clear distinctions are made between directors non-executive (“administrateur”) and executive directors by the legislation as well as in practice. There can be as many as 18 directors non-executive whilst the executive directors are limited in number (Chairman, Chief Executive and Deputy Chief Executive for ordinary public limited companies or members of the Management Board for companies which have chosen the dual structure).

Directors non-executive remuneration has never been a subject of discussion or debate[1].

Only the remuneration of the executive directors (Chairman, Chief Executive and Deputy Chief Executive or members of the Management Board) attracts the attention of economic observers and the general public. This remuneration is fixed by the Board of Directors or the Supervisory Board, and is not governed by a regulated agreement or any kind of agreement. The case law has always considered this to be a unilateral act by the Board of Directors which has exclusive competence to take this decision. It is a well-established rule of French case law that nobody can encroach on the competences of other bodies. Consequently the general meeting cannot take a decision concerning the Board of Directors and decide the remuneration of the executive directors.

2/ The exceptions

In 2005 and 2013 two exceptions (post-mandate remuneration and the French *say on pay*) were made to this principle of the competence of the board of directors.

Since 2005 certain kinds of remuneration of executive directors corporate agents of listed companies have been subject to regulated agreements (“convention règlementée). This concerns remunerations paid upon termination of the corporate mandate office or thereafter i.e. golden parachutes severance payments and supplementary pension commitments paid by the company. This procedure involves 3 steps: the Board’s prior approval, the preparation of a special report by the statutory auditors and the approval given ratification by the Ordinary General Meeting.

This exception to the principle of the exclusive competence of the board can be explained, from the point of view of legal principles, by the fact that these types of remuneration established by practice, have not been prescribed by law and therefore are treated as agreements.

In addition, since 2013 a form of “*say on pay”* has been established in the AFEP-MEDEF Code for the Corporate Governance of Listed Companies. A resolution should be submitted annually to the General Meeting on all remuneration due or granted to each executive director during the past financial year. This is a consultative resolution. The sanction provided by the AFEP-MEDEF Code is that if the resolution is not passed, the board must decide quickly on the

[1] This remuneration (directors’ fees) is fixed by the meeting. It generally does not pose any problem especially as in French law, this only involves fixed remuneration in cash, where the amounts paid are relatively small compared to European averages.

consequences it draws and publish its decision. This obligation applies to companies which have chosen to refer to the AFEP-MEDEF Code pursuant to the 2008 law which, in accordance with European legislation, requires listed companies to apply a corporate governance code and to explain why eventually they do not apply it. This is a *soft law* obligation: companies are free not to comply with it provided that they explain why (the experience in the first year of application showed their adherence with very few exceptions). However, this only concerns companies which have chosen to refer to the AFEP-MEDEF Code i.e. very large caps which in practice are those with very high remunerations. The legislator abandoned legislate on this subject, partly because imposing such a rule would be contrary to the above principles. The introduction of a new standard, when the recently introduced regime is having a promising beginning, would exacerbate the legal uncertainty which businesses are suffering in a difficult economic climate.

3/ A principle to be preserved

The *ex-ante* fixing of the remuneration of executive directors, which the French and German legislators have given to set up, pose considerable practical problems. An executive director sometimes has to be replaced in emergency and the choice of a successor is a crucial decision for the company and should not be affected by uncertainty on the terms of his pay package. The accidental death of the chairman of one of France's largest companies recently, which was widely reported in the press, showed how necessary it was to react very quickly in such a situation. It is not always appropriate to identically reproduce, even temporarily, the method of remuneration adopted often many years before for the predecessor, for a candidate chosen either from outside the company or in an internal promotion. A General Meeting in a large listed company is a cumbersome, time consuming and costly procedure while a board of directors or a supervisory board can react very quickly.

The board is therefore the most suitable body for deciding the remuneration of executive directors. There was a very real fear of partiality or complacency by the board in this area in the countries of continental Europe although there are far fewer executive members than in US/UK companies. However the numerous reforms in recent years including the introduction of the consultative *say on pay* have greatly reduced the risks in this regard.

B. The incompatibility of the proposal with the legal categories of continental law

The Commission's proposal is inconsistent with certain legal categories underlying the French law. It thus poses serious technical problems from the perspective of a transposition in our country:

- it targets *"administrateurs"* (which is the literal French translation of the English word "*director"*) while it is clearly intended to legislate on the remuneration of executive directors, a quite different category under French law ;
- amongst other things, it targets the "main clauses of the contracts of directors", while in French law the directors of listed companies are normally not bound to the company by an employment contract;

- If the reference to a contract applies to another contract than the employment contract, the application of this provision in French law is more than problematic to the extent that the relationship between executive directors and the companies is not contractual.

We will add that the focus on the control of executive directors remuneration by shareholders is not a "French exception" It is found in other continental laws where "*say on pay*" has been introduced, starting with German law. The Act of 31 July 2009 on the appropriateness of the Management Board's remuneration ('*Gesetz zur Angemessenheit der Vorstandsvergütung*'), which came into force on 5 August 2009, concerns, as its name indicates, the members of the Management Board and not the members of the Supervisory Board. The bill passed by the Bundestag in June 2013 and since abandoned, which included passing from an advisory vote to a binding vote by the General Meeting, only concerned the Management Board's remuneration. Fixing it remains the prerogative of the Supervisory Board.

II. Related Party transactions

The essential idea of the proposed directive in this area is to distinguish according to the size of the object of the agreement (art. 9 quarter).

Above an amount of 1% of assets, an independent third party has to write a report assessing whether the transaction is to market conditions and is fair and reasonable. The agreement and the report are published.

Above an amount of 5% of assets, the transaction must be approved by the General Meeting before the conclusion of the contract. This applies even if the transaction has a significant impact on profits or turnover.

Other interesting measures accompanying the latter provision, such as the measure that enables to enter into an agreement, subject to approval by the General Meeting.

This proposal calls forth several comments:

A. The content of the proposal

It is important to remember that the concept of related parties is originated in international accounting standards. This rule was created to provide information and more precisely to "draw attention to the fact that the financial position and net income may be affected"[2] by transactions between related parties.

It goes without saying that the use that is made here is far removed from its primary function. And one may wonder if the passage of an information rule to a rule to allow sanctioning conflicts of interests can be as easy as Article 9 quarter of the proposal seems to admit. Two aspects are noteworthy:

1/ The problems posed by the thresholds.

[2] IAS 24 standard

It should first be aware of the vast scope of related party transactions. The definition of related parties in the AIS 24 accounting standard encompasses a large number of legal or natural persons in relation with the contracting company. Because it is impossible to extend the information to all transactions with all related parties, the accounting legislation set a threshold of "significant importance". One could challenge this criterion which was in the hands of the contracting company. However the legal control of conflicts of interests requires more detailed rules. This is what is provided in Article 9 (quarter), which only applies to transactions above the threshold of 1% and 5% of total assets.

However, this is a considerable amount for a large company and especially for a listed company. Professor Schmidt gives an example concerning the threshold of 1% of assets which is very illustrative. "Knowing that Total's consolidated assets amounted to €147000000000 in 2012, the group's parent company could spend an unlimited number of transactions without being obliged to publish them, providing the unit amount of each transaction did not exceed €1470000000"[3]. This fairly extreme example shows that the extension of the scope to a host of possible related parties prevents the transactions being identified individually. However it is these transactions that are the most problematic. If the transactions targeted are large financial transactions such as contributions, mergers or partial transfers of assets, it is questionable whether these large corporate transactions should not rather be subject to their own regulations, even if this means taking the conflict of interest into account as well, if this is not already done by the law that governs.

2/ The inappropriate use of an expert

Observer can then question the specific surveillance modality provided for transactions that exceed 1% of assets. The publicity of the transaction is accompanied by a "report from an independent third party assessing whether the transaction is performed under market conditions and confirming that it is fair and reasonable from the shareholders' point of view…" (art. 9 quater-1). The question is then whether this recourse to the expert an independent third party as stated in the proposal for a directive is totally appropriate. As much as it seems legitimate to call in an expert to assess the price of a transaction, so we can have doubts about its validity to judge the appropriateness of a decision of the company. The expert is surely competent to assess whether the transaction is performed under market conditions. But beyond this? Would it not out of his role? It is true that the wording of the proposal only mentions fairness and reasonableness. But one also knows that reasonableness (which is a way to refer to "judicious behaviour") requires a judgement on advisability.

The experience of French law confirms this doubt. When confronted with regulated agreements, the statutory auditor must only give an opinion on the balance of the transactions to not interfere with the company's management. It is the General Meeting which alone has jurisdiction to rule on the advisability of the transaction.

[3] Rev. soc. 2013, p. 403.

It may be feared that the European system proposed here neglects the natural limits of the powers of an expert. A judgement of advisability cannot be made by an expert, only by an organ of the company.

B. French and German law

These two laws are interesting in that they offer examples of established legislations which work relatively well.

1/ German law

There are at least two mechanisms that can deal with conflicts of interest in transactions.

Regarding transactions between the members of the Management Board and their company, § 112 of the *Aktiengesetz* provides that the company is represented in such cases by the Supervisory Board which concludes the contract instead of the Management Board.

Regarding transactions with a company that controls, §§ 291 et seq of the Aktiengesetz include specific provisions of the law relating to groups.Without going into a great deal of detail, it is interesting to note that these two mechanisms have a point in common which is the fact that the agreement in question is usually authorised or concluded with the express agreement of the company's supervisory bodies in the first case, and in the second case with the express agreement of the directing bodies under the control of the statutory auditors.

2/ French law

The agreements procedure is well established and involves a prior authorisation of the agreement by the Board of Directors and a subsequent approval of the agreement by the General Meeting. The agreement is null and void if the board has not received it and if the agreement is harmful to the company. If the General Meeting fails to ratify the agreement after a report by the statutory auditors, the liability of the directors may be engaged. The advantage of this system is that it allows the continuation of the agreement in all cases, providing that it is not prejudicial to the company.

3/ The comparison

The idea which results from a comparison of both systems is that a rigid and prior system of control protects the interests of the shareholders of the contracting company. No trigger threshold is provided by law. All agreements are covered. Of course the field of natural or legal persons concerned is more limited than the related parties field under the IAS 24 standard. However, this circle of shareholders is relatively well protected.

C. The debateable implementation of new rules

The underlying but unexpressed idea of the proposed directive is doubtless that the liability of directors should come naturally complement the system set up, especially when the agreement exceeds 1% of the company's assets. A report by the OECD for 2012 on this issue emphasises the interest from the courts intervention in the system for controlling agreements[4]. The French system of prior authorisation is considered to be unsuitable in the light of this. One has the impression that the draft directive is inspired by the same conception of US/UK inspiration as the OECD report. However, although the French system is not perfect and allows certain cases to escape through its net (the Order of 31 July 2004 sought to tighten up certain holes in the net), it has the advantage of allowing a prior control which means that litigation can be usually be avoided. Although the French regulated agreements procedure is frequently used, litigation is quite rare. The same appears to apply to German law.

D. A conceivable solution

The proposal for a directive mentions the use of safeguards to protect shareholders' interests (recital 19). In doing so it reasons as if this protection had to be invented from a clean slate. However, certain experiences in some States are of interest. Would it not be better to lay down basic rules that can be used by all rather than imposing a system that is essentially based on the tendency for players to litigate, at least for agreements over 1% ? In fact, an agreement by the General Meeting is only required above 5%.

The proposed directive may impose that any agreement which directly or indirectly implicates important directors or shareholders must be authorised by the board and/or by the General Meeting with the director or shareholder concerned not taking part in the vote.

III. The shareholders' commitment

The proposed directive encourages the shareholders' concrete and lasting commitment by inserting measures to increase the transparency of the strategy of institutional investors and asset managers in the Directive 2007/36 :

- institutional investors and asset managers must develop a commitment policy of shareholders and annually publish the way their investment strategy is aligned with their commitments ;
- when they use asset managers, institutional investors must publish the main aspects of the agreement made in their name, and the asset managers must communicate how the investment strategy complies with the asset management agreement.

[4] P.H. Conac, Rev. soc. 2012, p. 466.

This proposal, which would be applicable to all institutional investors, suggests that today's shareholding is far more stable than in the past. Although this remark is justified by the entry of investment funds from US/UK sources into corporate capital, it must be relativized given the shareholding structures and the specificity of national rules on financial intermediation.

A. The diversity of shareholding structures

Institutional investors have become important collectors of savings and issuers on the financial markets, following the deregulation of foreign exchange controls in Europe, the waves of privatisation in some countries like France and the globalisation of the financial markets in general. Their structures are different, including insurance and investment companies, pension funds, to which alternative funds like *hedge funds* have recently been added. A study by the OECD confirms that the generic term "institutional investor" does not really provide clear information on the characteristics, capacity or degree of commitment of these investors. Behind the concept of "engagement" are hiding even very different realities, with differences in strategy existing inside the categories of investors[5], from a sustained dialogue with companies to a much more "activist" approach.

In continental law countries, the entry of institutional investors into corporate capital has somewhat modified the directors' relationships with shareholders. However this opening has been gradual and the traditionally concentrated shareholding structures have helped to maintain the dialogue with directors. In France, the Anglo-American funds are still a minority (around 40% of the stock market capitalisation of the CAC 40), whilst traditional investors like banks and insurance companies are extremely active here. Moreover, UCTIS funds have liabilities which represent 15 to 20% of the free float market capitalisation of the CAC 40 and the SBF 250, to which various employee savings vehicles must be added. A specific method of governance in Germany, oriented towards employees' interests, has attracted long-term funds[6]. The involvement of institutional investors remains low in Italy (23% compared to 31% at the European level), but this has not prevented shareholders' rights being continually reinforced since 1992[7]. Facing shareholding structures more or less concentrated, companies' requirements are inevitably different, and the harmonisation of the rules must remain very flexible.

B. French law

French law governs in an original way the behaviour of institutional investors and management companies.

1/ The limits imposed by interest of the company.

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[5] S. Celik et M. Isakkson, Institutional investors and ownership engagement, OCDE Journal: financial market trends, vol. 2013/2, 2014.

[6] M. Goyer, *Contingent capital- short-term investment and the evolution of corporate governance in France and in Germany*, Oxford University Press, 2011, spec. ch. 5, p.219 et s.

[7] M. Belcredi et L. Enriques, Institutional activism in a context of concentrated ownership and high private benefits of control: the case of Italy, ECGI, Law working paper, n°225/2103, March 2014.

The interest of the company is an important safeguard against excessive demands of shareholders. In the French approach it is generally recognised that the shareholders' specific interest should not be confused with the interest of the company. In this line, the AFEP-MEDEF's Code of Corporate Governance for Listed Companies gives the board of directors the power to exercise the "the powers conferred to him by law to act in all circumstances in the best interests of company. This definition suggests to take into account all the interests which companies are guarantors, exceeding the purely selfish behaviour: the value created benefits for both shareholders and stakeholders of the company. The shareholder value defended by the agency theory in Anglo-American countries - which is limited to the relationship shareholders-directors, is replaced by the idea of creating long-term value for the benefit of. Of course, determining the company's interest is complex, and leaves the board of directors a certain room for appreciation in its action. But this discretion is the mark of governance that is able to adapt to the needs of the moment, and subsequent control of the judge intervenes to settle a last resort.

German law is also focused on promoting a broad company interest, which, notably, makes employees' interests part of the company's strategy. This is illustrated by the presence of a significant proportion of employee representatives in the supervisory board (from one-third to half depending on the size the company), a presence that serves as a counterweight against the more "short-termist" interests of shareholders. In these laws the shareholders' commitment is necessarily measured in terms of interest of the company.

2/ The limits of the proposal

The proposed directive does not say whether, in management companies, the establishment of a commitment policy includes the voting policy. The legislation in France has evolved, and now requires these companies to exercise the voting rights attached to the securities held by the UCITS (Art. L. 533-22 of the Monetary and Financial Code), this role being subject to the "*comply or explain"* principle. Finally this mechanism is supplemented by the AMF's general rules, which require the elaboration of a voting policy that management companies must annually report on (RGAMF, Arts. 314-100 to 102). The diffusion of this voting policy necessarily informs the market of the forms of the investor's commitment and its investment policy. It would be desirable to introduce this mechanism in the Directive 2007/36.

Conversely, the proposal appears to be superfluous concerning the management of conflicts of interest. The agency problems which exist between the issuing company, the Management Company and investors are related to the fact that management companies belong to larger financial groups which offer financial services, and which are also supports for the financial management activity. Conflicts of interest are not unknown inside these financial groups. The question is therefore an essential one. However the proposal for a directive does not appear to take account of European texts being transposed by Member States[8], supplemented by the ESMA guidelines, or those of the EFAMA. Add a new regulation seems premature, and

[8] A case in point being the Directive 2009/165 on UCITS (Art. 17 à 20), the AIFM Directive on Alternative Funds (art. 30-36), and as these companies usually offer investment services ; they are also subject to the MIF 2 Directive which reinforced the regulation of service providers regarding conflicts of interest.

prudence added to the subsidiarity principal suggests only legislating on this point after impact studies on these texts once transposed.

By imposing an obligation to publish the agreements concluded between institutional investors and asset managers, the proposed directive also appears to draw inspiration from certain practices that are not transposable in France, because French UCITS do not conclude such agreements with their shareholders.

C. A conceivable solution

Continental laws are gradually adapting to the problems posed by the arrival of new types of shareholders without losing sight of the interest of the companies they govern. A very flexible harmonisation at the European level would fit, which should provide to add the voting policy to the list of elements defining the commitment policy of institutional investors.

However, providing transparency rules for all investors leads to the imposition of additional costs requiring significant resources. The principle of proportionality here could serve as a guide for the work of the European institutions to limit the obligations of transparency for investors who hold a significant stake in a company. Put simply, it should not be excluded on the category of funds the "*mutual funds"* which are excluded from the proposed d should be included within the directive.