The Shareholder Rights Directive II – A catalyst for shareholder activism?

1. What is new for shareholders?

1.1 Framework for increased shareholder activism

The Shareholder Rights Directive II (SRD II)[1] might turn out to be the EU's most compelling legislative attempt to **elevate the shareholders of listed companies into the position of effective decision-makers at their companies.** The SRD II builds on an existing framework of shareholders' rights introduced in 2007 by the Shareholder Rights Directive I (SRD I)[2], whose transposition date was 3 August 2009.

The threat of the EU infringement procedure is looming for EU member states that have missed the SRD II's basic transposition date of 10 June 2019, including Romania, which currently has a draft law on the transposition of the SRD II under consideration. The date of application of the European Commission's Implementing Regulation 2018/1212/EU in respect of articles 3a, 3b and 3c (described in Sections 2.3, 2.4 and 2.5 below) is 3 September 2020 (the Implementing Regulation is directly applicable).

In our view, the SRD II creates the framework for strengthened corporate governance in listed companies, the trickle-down effect of which we believe will act as a catalyst for increased shareholder activism.

The key features of the SRD II framework are as follows:

Ø The SRD II, as an amending directive, extends the scope of the SRD I by introducing measures to encourage shareholder engagement;

Ø The main say-on-pay influence of shareholders lies in their right to vote on the company's proposed remuneration policy at the general meeting, through a mandatory, binding vote;

Ø Companies may only pay their directors according to a remuneration policy that has been approved by shareholders;

Ø The remuneration report of the most recent financial year, which is subject to an advisory vote, sets out, *inter alia*, the total directors' remuneration split by component and the relative proportion of fixed and variable remuneration;

Ø Material transactions with related parties must be publicly announced and must be approved by the general meeting or by the management body;

Ø The SRD II introduces far-reaching provisions on the facilitation of the exercise of shareholders rights, identification of shareholders and

transmission of information;

Ø Institutional investors and asset managers must develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy;

Ø Proxy advisors must publicly disclose information annually on the preparation of their research, advice and voting recommendations;

Ø On 5 June 2019, the Romanian Ministry of Public Finance published a draft law that amends a number of normative acts, in order to transpose and give effect to the SRD II in Romania. The public consultation process concluded on 5 July 2019, and it is expected that the normal legislative process will be followed in the Romanian Parliament;

Ø In view of the delay to Brexit, the UK transposed the key parts of the SRD II into UK law on 10 June 2019.

1.2 Building upon existing minimum rights

In 2007 the Shareholder Rights Directive (SRD I) was adopted (still in force), serving as a trailblazer for the granting of **minimum rights for shareholders of listed companies across the EU**. Institutional investors, in particular, benefited under the SRD I from the introduction of rights including timely access to prescribed information pertaining to general meetings, the rights to vote by proxy and by correspondence (the latter right is left to the discretion of the company), and the elimination of certain impediments to voting, including the removal of share blocking.

The SRD II does not intrude on the existing scope of application of the SRD I, which remains limited to the exercise of certain shareholder rights in relation to general meetings of companies which have their registered office in an EU member state and the shares of which are admitted to trading on a regulated market situated or operating within a member state. However, the **SRD II, as an amending directive, extends the scope of the SRD I by introducing specific requirements into the SRD I in order to encourage shareholder engagement**, in particular in the long term.

2. Will shareholders become more effective decision-makers?

The SRD II introduces impactful new rights and obligations for, *inter alia*, companies, directors, shareholders (notably, institutional investors), intermediaries[3], asset managers and proxy advisors.[4] In our view, the SRD II succeeds in strengthening shareholders' rights at listed companies by introducing compelling obligations on companies to enable the effective participation of shareholders in corporate decision-making. **The rights and obligations introduced by the SRD II cover the following topics:**

2.1 Remuneration of directors: Shareholders' "say-on-pay"

For many EU member states, the most compelling novelty introduced by the SRD II are the provisions relating to the power granted to shareholders to decide on the approval of remuneration policies for directors, and the disclosure of director remuneration information, together known informally as **"say-on-pay"**.

2.1.1 Remuneration policy

The primary say-on-pay influence of shareholders lies in their SRD II **right to vote on the company's proposed remuneration policy** at the general meeting. Not only are companies now required to establish a remuneration policy, but the shareholders are required to vote thereon. This vote is **binding** (unless EU member states decide to make the vote advisory – in Romania's draft transposition law, the vote is binding), meaning that **companies may only pay their directors according to a remuneration policy that has been approved by**

shareholders. Nonetheless, if it is necessary to serve the long-term interests and sustainability or viability of the company, the company may be allowed to temporarily derogate from the remuneration policy. Clearly, such a derogation may face resistance from shareholders, who will likely become emboldened by the strengthening of their say-on-pay rights. In Romania's draft transposition law, there are exceptions to the requirement for a binding vote on the remuneration policy, i.e.:

1. **If there is not yet an approved remuneration policy**, and the shareholders' general meeting does not approve the proposed policy, the company may continue to remunerate its directors in accordance with its existing practices; and

2. **If there is an approved remuneration policy**, and the general meeting does not approve the new proposed policy, the company may continue to remunerate its directors in accordance with its existing approved remuneration policy, and the company should present a revised policy for approval at the next general meeting.

Every time there is a material change to the remuneration policy and, in any event **at least every four years, the remuneration policy must be submitted to a vote** by the general meeting (following the vote, the remuneration policy must be made public). The remuneration policy, unlike individual remuneration agreements with particular directors, will contain a high-level overview of the fixed and variable remuneration components and weightings payable to directors, including cash bonuses and other benefits in whatever form. For variable remuneration (typically the largest component of remuneration), this will require detailed explanations of *inter alia*, financial and non-financial performance metrics at both company and individual director level, performance deferral/vesting periods, minimum threshold levels for payout, claw-back and malus conditions, and any applicable discretionary powers afforded to the company's remuneration committee. The remuneration policy will need to include the terms of payments linked to the termination of directors' mandates, which means that the SRD II may make it **more difficult for companies to award non-performing retiring directors with generous "golden parachute" payouts** upon a change of control or upon a controversy-marred departure from the board.

2.1.2 Remuneration report

The remuneration policy is only one component of the broader say-on-pay right, which extends also to the remuneration report, in which the company specifies the **overview of remuneration actually paid or due to individual directors in the most recent financial year**. The company is required to compile a remuneration report that sets out, *inter alia*, the total remuneration split by component and the relative proportion of fixed and variable remuneration. For example, the report should state the number of shares and share options granted or offered, and the conditions for the vesting of any share awards.

The **remuneration report of the most recent financial year is subject to an advisory vote** by the annual general meeting, with the shareholders thereby gaining the right to convey their disagreement on "pay for failure". The vote, despite being advisory, cannot be ignored by the company, which is required to explain in the following remuneration report how the say-on-pay vote cast by the general meeting has been taken into account. Member states may decide to exempt small and medium-sized companies from a vote requirement, instead providing for a discussion in the annual general meeting as a separate item on the agenda. After the vote, the remuneration report must be made public.

2.2 Related party transactions

The SRD II measures on material transactions with related parties are aimed primarily at reducing conflicts of interest. **"Material transactions"** are defined in Romania's draft transposition law as any transfer of resources, services or obligations, irrespective of whether or not they involve the payment of a price, which have an individual or cumulative value representing more than 5% of the issuer's total income. **Material transactions must be publicly announced by companies if they involve related parties**, at the latest at the time of the conclusion of the transaction. The announcement must describe, *inter alia*, the nature of the related party relationship and the date and value of the transaction. The purpose of this disclosure is to enable an assessment of whether or not the transaction is fair and reasonable from the perspective of the company and shareholders (especially minority shareholders). Member states also have the possibility to require the announcement to be accompanied by an independent report on fairness and reasonableness.

According to the SRD II, material transactions with related parties must be approved by the general meeting or by the management body of the company (in Romania, the draft transposition law requires the approval of the board of directors or the supervisory board), in such a manner as to prevent the related party from influencing the outcome of this approval, meaning the non-participation of the related party in the approval vote, unless national law ensures appropriate safeguards. Member states may exclude the above related party formalities from, *inter alia*, transactions between the company and its wholly owned subsidiaries, transactions relating to the remuneration of directors, and transactions offered to all shareholders on the same terms.

2.3 Facilitation of exercise of shareholders rights

Intermediaries are required to facilitate the exercise of rights by the shareholder, including the right to participate and vote in general meetings, which should comprise at least one of the following: (i) the intermediary should make the necessary arrangements for the shareholder or a third party nominated by the shareholder to be able to exercise the rights themselves; or (ii) the intermediary should exercise the rights flowing from the shares upon the explicit authorisation and instruction of the shareholder and for the shareholder's benefit. When votes are cast electronically, an electronic confirmation of receipt of the votes should be sent to the person that casts the vote. After the general meeting the shareholder or a third party nominee is entitled to obtain confirmation that their votes have been validly recorded and counted by the company.

2.4 Identification of shareholders

Companies should have the **right to identify their shareholders**. This right is facilitated by the requirement for intermediaries to communicate without delay to the company the information regarding shareholder identity. However, EU member states have the discretion to provide for companies having a registered office on their territory to be only allowed to request the identification of shareholders holding more than a certain percentage of shares or voting rights, provided this percentage does not exceed 0.5%. The ease of identification of shareholders enabled by these provisions will enable the company to **communicate with shareholders directly and efficiently**, to facilitate the exercise of shareholder rights and shareholder engagement. There are also provisions on data retention and the right of rectification of incomplete or inaccurate information, thereby aligning the SRD II with EU Regulation 2016/679 on the protection of personal data (the General Data Protection Regulation, "GDPR").[5]

2.5 Transmission of information

The SRD II requires that **intermediaries should transmit certain information from the company to the shareholder** in order to enable the exercise of the rights deriving from holding the respective shares. Companies will be required to provide the information to the intermediaries in a standardised form. However, the transmission of information through intermediaries will not be required when companies send the information directly to all their shareholders. Intermediaries will additionally be required to transmit to the company information received from the shareholders related to the exercise of the rights flowing from their shares. The streamlined transmission of information is intended to make it easier for shareholders residing in another EU member state than that in which the investee company is based to exercise shareholder rights in the company's general meetings.

2.6 Transparency of institutional investors, asset managers and proxy advisors

2.6.1 Institutional investors and asset managers

Institutional investors and asset managers must develop and publicly disclose an **engagement policy that describes how they integrate shareholder engagement in their investment strategy**, and must disclose annually how the engagement policy has been implemented, unless member states permit a reasoned explanation as to why these requirements have not been complied with. The publication of the engagement policy and of the implementation information enable an assessment of how institutional investors and asset managers have monitored investee companies, exercised voting rights, cooperated with other shareholders, and managed conflicts of interest. The aim of the disclosure requirements is to encourage investors to adopt a more long-term focus in respect of investment strategies, in which they consider stakeholder issues.

Moreover, institutional investors must publicly **disclose how the main elements of their equity investment strategy are consistent with the profile and duration of their liabilities**. Where an asset manager invests on behalf of an institutional investor, the institutional investor must publicly disclose certain information regarding its arrangement with the asset manager, notably on the alignment of investment strategies. Finally, asset managers must disclose annually to the institutional investor with which they have concluded arrangements, how the investment strategy complies with the arrangement.

2.6.2 Proxy advisors

Proxy advisors must publicly disclose reference to a code of conduct which they apply, and report on the application of that code of conduct. Where proxy advisors do not apply a code of conduct (or deviate from its recommendations), they should provide a clear and reasoned explanation as to why this is the case. An unprecedented feature for many member states is the introduction of the requirement for **proxy advisors to publicly disclose information annually on the preparation of their research, advice and voting recommendations**,

including the essential features of the methodologies and models they apply. In this regard, pressure will mount on proxy advisors to justify their recommendations, which tend to be relied upon by important institutional investors. The intended trickle-down effect is to promote more informed decision-making by shareholders at general meetings.

3. What does increased shareholder activism mean for you?

As discussed above, the SRD II introduces numerous unprecedented shareholder rights and obligations, which will **affect the following stakeholders in particular:**

3.1 Companies

Companies will be required to adopt multiple structural changes in order to comply with the SRD II, not least of which will be the requirement to compile a remuneration policy and a remuneration report, which should be put to the vote of the general meeting, subject to the permissible derogations by individual member states discussed in Section 2.1 above.

While the SRD II does not expressly require the setting up of a remuneration committee, it is difficult to conceive of how the company will be able to discharge the onerous say-on-pay requirements without proper **strategic direction and technical expertise from a separate board-level remuneration committee.** Most EU stock exchanges' corporate governance codes recommend that main market-traded companies should set up independent remuneration committees that benefit from delegated responsibility (from the board) to determine the policy for executive director remuneration and to set the remuneration payable for the chair, executive directors and senior management.

In relation to the actual disclosure of remuneration, the company should take note of the risk of liability under the GDPR's strict provisions on safeguards on the processing of personal data. Therefore, in the remuneration report, companies should exercise data minimisation by processing only the personal data which is required for the purpose of increasing corporate transparency as regards directors' remuneration in order to enhance directors' accountability and shareholder oversight over directors' remuneration.

3.2 Directors

The shareholders' say-on-pay on the remuneration policy and remuneration report is likely to increase the **pressure on directors to demonstrate the objective alignment between the remuneration received and their actual performance**. This may lead to more scrutiny over individual directors and, in the case of poor-performing directors, to the risk of a humiliating removal from the board by shareholders and to career-damaging media attention over "shareholder revolts".

Secondly, as a director, you may be justifiably concerned that the publicly disclosed remuneration report, which sets out the remuneration you actually received in the most recent financial year, will expose you to unwanted disclosures of personal data. However, you are protected by the SRD II's requirement that companies must not include in the remuneration report any family information or any of the special categories of personal data of individual directors within the meaning of article 9(1) of the GDPR, including racial or ethnic origin, biometric data, political opinions, or religious or philosophical beliefs. Furthermore, the maximum default publicity period for your personal data contained in the remuneration report is 10 years from the publication of the remuneration report.

3.3 Shareholders and asset managers

As a shareholder, **you are offered a range of new decision-making powers and rights aimed at enabling your engagement with the company**. The extent to which you use these rights and powers to advance your interests in exerting change over the governance of the company depends to a large degree on your initiative and ability to coordinate with other like-minded investors. You should recall that, because the SRD II is an amending directive in relation to the SRD I, your existing rights under the SRD I, including the rights to vote by proxy and by correspondence, and the elimination of certain impediments to voting, should be used in conjunction with the new rights

introduced under the SRD II.

As an institutional investor or asset manager, you are required to develop and publicly disclose a shareholder engagement policy. This will require **strategic planning on the criteria for monitoring investee companies**, including on financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance. In effect, the SRD II expects you to integrate shareholder engagement into your investment strategy, thereby expanding your investment approach beyond financial considerations, to additionally cover *inter alia* the ways in which you exercise voting rights, cooperate with other shareholders and manage conflicts of interest. This integration will be aided by greater access to objectively verifiable voting recommendations from proxy advisors, in view of the requirement that proxy advisors should publicly disclose information annually on the preparation of their research, advice and voting recommendations. This transparency will help you to make informed decisions on the substantive merits of how to cast your votes on important items at the general meetings of investee companies. A structured approach will need to be put into practice in view of the requirement to publish annually how the shareholder engagement policy has been implemented, notably in respect of the manner in which you have cast significant votes in general meetings.

3.4 Intermediaries

As an intermediary, you will be expected to play a key role in (i) facilitating the exercise of the rights by the shareholder, (ii) enabling companies to identify their shareholders, and (iii) transmitting certain information from the company to the shareholder in order to enable the exercise of the rights deriving from holding the respective shares. These roles will require you to, *inter alia*, **enable the shareholder to exercise the right to participate and vote in general meetings**, involving crucial administrative formalities that permit the shareholder to exercise meaningful decision-making power at the company.

3.5 Proxy advisors

You will be subject to far more scrutiny than has previously been the case, in view of the requirement to publish reference to a code of conduct and to report on its application, as well as to publish information annually on the preparation of your research, advice and voting recommendations. In this respect, the objectivity of the methodologies and models used, and the independence of services rendered (including the absence of conflicts of interest) will be paramount. These **transparency requirements will have the effect of making the value proposition of your particular services towards institutional investors more dependent on your performance in the past**.

4. Implementation of the SRD II in Romania

On 5 June 2019, the Romanian Ministry of Public Finance published a draft law[6] that amends a number of normative acts, including Law no. 24/2017 on the issuers of financial instruments and payment operations, in order to transpose and give effect to the SRD II in Romania (the "Draft Law"). In order to have a unitary approach and to avoid successive changes to the legislation, all the provisions of the SRD II are to be transposed through the Draft Law. The Draft Law stipulates that the SRD II provisions on facilitation of the exercise of shareholders' rights, identification of shareholders, and transmission of information are to enter into force on 3 September 2020.

Following the public consultation process, which concluded on 5 July 2019, it is expected that the Draft Law will be brought before the Romanian Parliament under the normal legislative process. It is unknown at this stage when the legislative changes brought about by the Draft Law will enter into force so as to transpose the SRD II into Romanian law, but we anticipate that EU regulatory pressure will be high because Romania has already missed the SRD II's basic transposition date of 10 June 2019.

5. Impact of the SRD II in relation to Brexit

The **impact of the SRD II on the United Kingdom may not be as significant as for other EU member states**, especially as regards directors' remuneration because the UK Companies Act 2006 already has a "say-on-pay" voting requirement both for the remuneration policy (binding) and the remuneration report (advisory). Nonetheless, in view of the delay of Brexit, the UK transposed the key parts of the SRD II into UK law on 10 June 2019 through the Companies (Directors' Remuneration Policy and Directors' Remuneration Report) Regulations 2019, the Shareholder Rights Directive (Asset Managers and insurers) Instrument 2019, and the Listing and Disclosure Sourcebooks (Shareholder Rights Directive) Instrument 2019.

6. How can you get ready for the SRD II?

As with any new EU Directive that requires possible structural changes to your business, a thorough approach to **SRD II compliance will involve the following key stages:**

6.1 Gap analysis

Firstly, you should identify whether the SRD II's scope of application covers your particular entity, following which you will need to understand which category of rights and obligations applies. A gap analysis will enable you to trace the necessary steps to be taken by your entity in order to **move from an "as-is" to a "to-be" outcome**. Before embarking on a gap analysis, it may be prudent to designate dedicated SRD II internal task teams to undergo comprehensive training courses on the impact of SRD II.

6.2 Document drafting

The SRD II requires regulated entities to compile numerous **documents that give effect to the respective shareholder rights**, including engagement and remuneration policies, remuneration reports and various other public information disclosures. Given that many of these documents might never have been contemplated by the entity before, these documents will require skilful drafting by legal experts.

6.3 Process review

The proper implementation of documents and corporate decisions requires corporate processes that are consistent with the stated aims. This may involve significant **changes to the existing corporate governance structure**, including to reporting lines, authorised persons, the conduct of general meetings, information disclosures to shareholders, and risk mitigation in respect of activist shareholder litigation.

6.4 Implementation

Once the gaps have been identified, documents have been drafted and processes developed, the strategic planning must be put into effect through **binding corporate decisions** that are approved by the respective decision-making bodies, which might include the board, board committees and the general meeting of shareholders.

As experts and international practitioners in the field of corporate governance and shareholders' rights, **KPMG Legal and KPMG are well placed to help you harness the opportunities of the implementation of the SRD II in relation to your corporate entity as well as to limit the risks.**

---

1. Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

2. Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

3. Defined by art. 1(2) of the SRD II as a person, such as an investment firm, a credit institution and a central securities depository, which provides services of safekeeping of shares, administration of shares or maintenance of securities accounts on behalf of shareholders or other persons.

4. Defined by art. 1(2)(g) of the SRD II as a legal person that analyses, on a professional and commercial basis, the corporate disclosure and, where relevant, other information of listed companies with a view to informing investors' voting decisions by providing research, advice or voting recommendations that relate to the exercise of voting rights.

5. Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).

6. http://e-consultare.gov.ro/w/proiect-lege-pentru-modificarea-si-completarea-unor-acte-normative-precum-si-pentru-stabilirea-unor-masuri-de-punere-in-aplicare-a-regulamentului-ue-2017-2402-al-parlamentului-european-si-al-consil/