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Shareholder Rights Directive: Advancing to a State of Readiness



IN ASSOCIATION WITH

Aite

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EXECUTIVE SUMMARY

The updated Shareholder Rights Directive (SRD) may seem like an addendum to the original 2007 directive, and the transposition period may give an impression of there being plenty of time for firms to prepare for it, but rather like Brexit, the clock has already started ticking and there are complexities that need to be addressed. Without robust analysis, the implementation of revised operating models and more transparent reporting, firms across the shareholder communication chain will be found wanting come 2019 if they do not act promptly.

Examination of processes, technology solutions and business models will be required by:

Issuers and registrars:

- Standardisation of meeting announcements and provision of vote confirmation
- Increased scrutiny on director remuneration and related party transactions

Institutional investors and asset managers:

- Deeper analysis on director remuneration and related party transactions
- Extended transparency of engagement strategies and policies

Custodians, proxy service providers and other intermediaries:

- Immediacy of transmitting voting information
- Proxy service fee structures
- Diversity of local national requirements
- New value add services

Early and effective engagement with regulatory authorities will be key to helping firms shape outcomes that are equitable and commensurate with the corporate governance benefits of the SRD. The industry as a whole has a new opportunity to take corporate governance forward.

Introduction

Corporate governance scandals across the globe and recent questions raised by the media about transparency and accountability have compelled regulators to take a close look at ownership and shareholder rights. For example, the influence of major overseas conglomerates on European financial institutions is under scrutiny in the region. The European regulatory community has also cracked down on corporate tax avoidance in the wake of revelations such as those from the Panama Papers in 2016.

In this light, the European Council adopted the new Shareholder Rights Directive (SRD) in June 2017 with the view of encouraging shareholder engagement in listed companies in Europe and improving the transparency of related processes, including proxy voting. SRD provides an update to the 2007 version of the directive and adds requirements related to remunerating directors, identifying shareholders, facilitating the exercise of shareholder rights, transmitting information, and providing transparency for institutional investors, asset managers, and proxy advisors.

The majority of the SRD must be translated into national law by individual European member states by June 2019. The directive is extensive and all the indicators are that it will entail significant and costly changes related to process reforms and transparency requirements, impacting issuers, asset managers, custodians, central securities depositories (CSDs), and a range of other intermediaries and service providers.

This white paper examines the challenges and opportunities related to the introduction of the new SRD requirements. It highlights required changes to the structure of proxy voting processes, the impact of these changes on operating models, and the potential actions that can be taken by industry participants to engage with the regulatory community as national regulation is drafted over the next two years. The white paper includes feedback from several custodians and intermediaries active in European markets.

THE DIRECTIVE

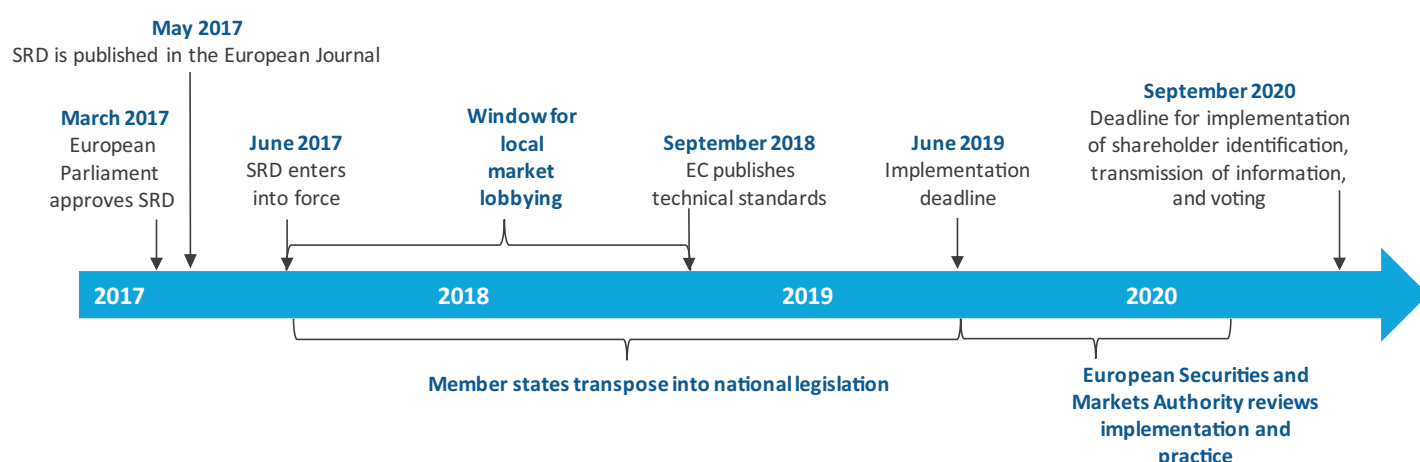
In April 2014, the European Commission (EC) issued its legislative proposal to amend the 2007 SRD, which focuses on increasing shareholder engagement and improving transparency in the exercise of shareholder rights and certain aspects of corporate governance. During the succeeding three years, the European-level regulatory bodies drafted the final version of the directive, and the final Level-1 text was published in May 2017, with a deadline for European member-state implementation in June 2019, though some requirements do not come into force until September 2020. The EC will work in consultation with the European Securities and Markets Authority to draft the regulatory technical standards that will provide guidelines to national regulators about the details of implementation.

The directive comes into force at a time when many other large and complex regulations will also be in flight. Regulatory compliance fatigue among industry participants could result in further challenges, as overburdened staff may fail to adequately assess required process changes or may miss implementation deadlines. Given the veritable alphabet soup of regulatory mandates that have stemmed from European regulators since 2008, many firms are likely to have missed out on SRD consultation opportunities with regulators. However, while SRD may have flown under the radar of many firms while it was drafted, its impact cannot be ignored.

Figure 1 shows the upcoming regulatory implementation milestones, beginning with the European Parliament approval of the final text of the directive in March 2017 and when it was published in the European Journal two months later. The two-year member-state transposition process will necessarily entail adaptation of the requirements to domestic market structure and local legal processes, which leaves some room for changes to requirements at the national level. If the gamut of firms impacted by the regulation—issuers, intermediaries of all kinds, asset managers, and investors—are to make a difference in implementing requirements, they will need to engage the EC and their national regulators effectively and promptly. Moreover, bearing in mind the catalogue of regulations in flight, firms cannot afford to ignore any of the impending deadlines, SRD's included.

SRD fits into a wider programme of work for European regulators; the programme is targeted at shaping the future investment landscape of the region and is part of its single Capital Markets Union plan. The EC is keen to foster an increase in shareholder activity and to see proof that companies understand their investors and communicate with them in a clear and transparent manner. The intents of the SRD to enhance investor engagement and to increase shareholder voting transparency are laudable, but the regulatory route to achieving those goals may bring industry challenges.

FIGURE 1: SRD TIMELINE



The EC wants to ensure that shareholder rights are not infringed and aims to do so in the SRD via a range of different institutional investor, intermediary, and asset manager transparency requirements. Buy-side entities will be asked to disclose their engagement policies and explain how their investment strategy aligns with long-term goals. Though increased transparency could lead to more engagement and dialogue between issuers and their shareholders as intended, regulatory prescription around the identification of these entities could cause a headache for firms operating in different

markets that must also abide by client data privacy regulations. And this is just one of the many challenges that firms will face in terms of practical implementation at the national level.

The EC has also added a range of new definitions for firms that are within scope of SRD (Table A), some of which—like “intermediary”—are very broad. The directive’s breadth of scope means that all of these various entities must review their respective obligations and alter their operational models accordingly.

TABLE A: SRD 2017 NEWLY ADDED DEFINITIONS

Party	Definition
Intermediary	Entities such as investment firms, credit institutions, and CSDs, which provide services including the safekeeping and administration of shares or the maintenance of securities accounts on behalf of shareholders or other persons
Institutional investor	Life insurance firms or institutions engaged in occupational retirement provision (pension fund)
Asset manager	Investment firms that provide portfolio management services to investors, alternative investment fund managers, and Undertakings for Collective Investment in Transferable Securities (UCITS) management companies
Proxy advisor	Individuals or firms that provide research, advice, or voting recommendations to investors about the exercise of the investors’ voting rights

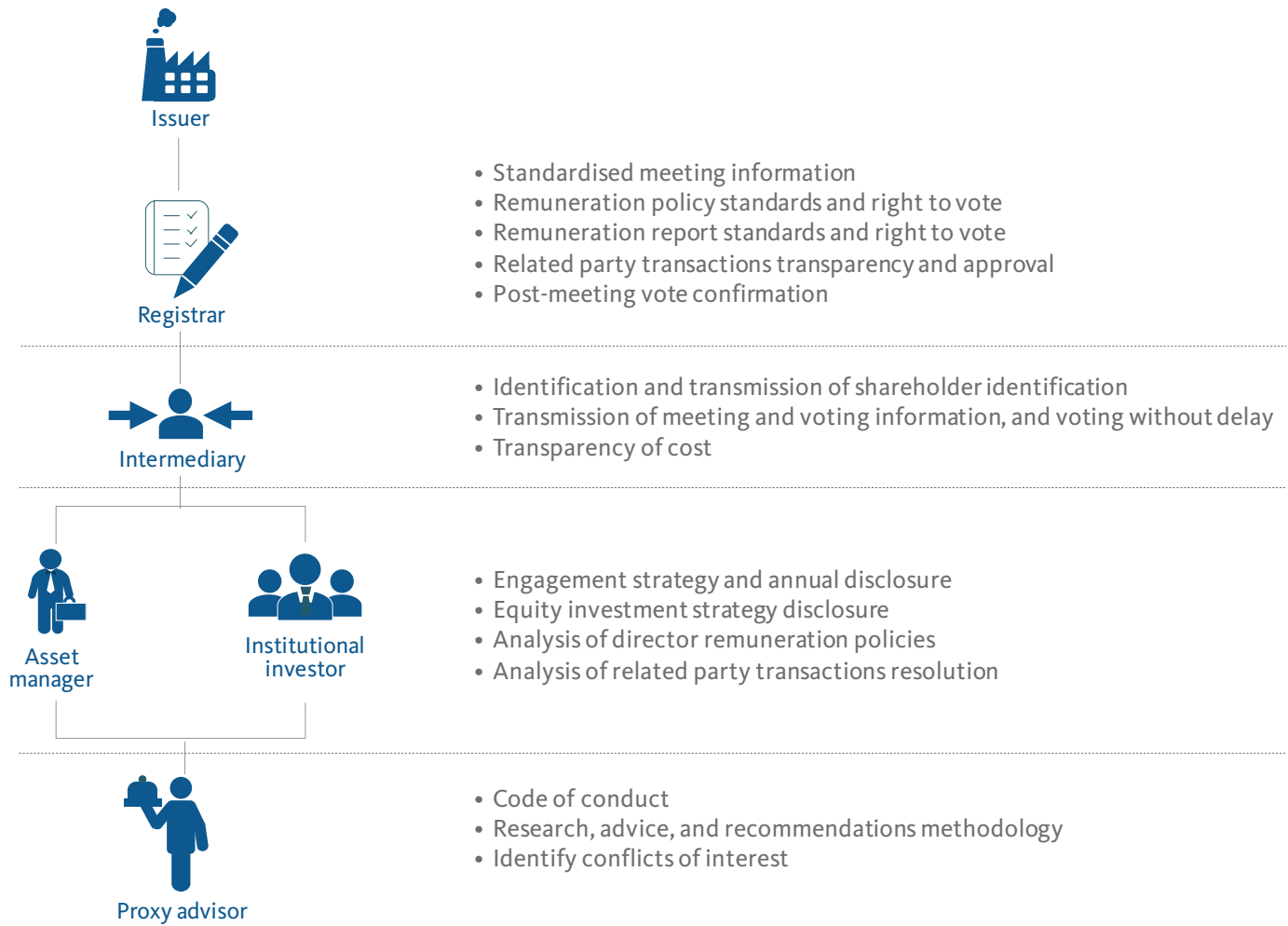
SOURCE: EC, AITE GROUP

Figure 2 shows the chain of entities that are in scope of the directive and the SRD themes relative to them. Under the requirements of the SRD, issuers will be granted the right to obtain shareholder identification with the objective of engaging directly with the investor. This means intermediaries (of all kinds) must provide “without delay” to the issuer information regarding shareholder identity, which implies that data must be provided in near real time.

Issuers must ensure that remuneration policies are disclosed to and voted on by shareholders at general meetings. Some transactions, such as intragroup transactions (between

two affiliates of the same holding company), must also be approved during general meetings. Institutional investors and asset managers must publish reports on their investment strategies for shareholders. Proxy advisors must establish “accurate and reliable” voting recommendations and will be required to publish reports containing key information about the preparation of their recommendation and advice. These entities must also report about their adherence to the code of conduct to which they apply or explain why they do not apply a code of conduct.

FIGURE 2: ENTITIES IMPACTED BY SRD AND KEY THEMES



Industry participants will be posed with challenges if national regulators opt for significantly different interpretations of SRD, as has happened with other areas of regulation such as the Financial Transaction Tax. A global custodian respondent indicates that the industry could be negatively impacted by national divergence because of the requirement to tailor

compliance efforts to each regulator’s interpretation. This would increase the complexity and cost of SRD implementation for firms operating in more than one market. Another securities services respondent believes that discrepancies in the dates of implementation in different jurisdictions will also pose a problem to global firms.


A FOCUS ON THE COMPLIANCE DETAILS

Many firms are unlikely to have assessed the full impact of SRD on their operations yet, but custodians are already concerned about certain headline items. Disclosure requirements for shareholder entity identification is one such area, and the wording of the directive around submission of data “without delay” is of particular concern to intermediaries, especially when applied before shareholder voting. National regulators could potentially interpret this immediacy as a requirement for real-time or near real-time reporting, which—given that multiple intermediaries may be required to transmit information along the chain—could be almost impossible under current market practices.

Shareholder information disclosure

A custodian respondent notes that national interpretation could also mean differences across markets around the minimum level of holdings that must be disclosed. One regulator, for example, could specify disclosure at 1% holdings, while another could require it at 0.5%, meaning what is reportable in one jurisdiction is not in another. For now, the data sets required to be reported remain relatively simple (Figure 3), though items such as legal entity identifier (LEI) may not be available for the entities in question, and other nationally specific identifiers will be required instead. SRD refers to providing data in a standardised format, but the directive does not specify the standards, and this may be provided as technical standards by the EC. The disclosure of these data items may, however, breach certain countries’ data privacy laws, which means national regulators are likely to be compelled to alter requirements accordingly.

FIGURE 3: MINIMUM REQUIREMENTS FOR SHAREHOLDER IDENTIFICATION



Name: John Doe

Address: 1 Shareholder Street, London

Email: john.doe@shareholder.com

LEI: 62830085UKLKJH93TE11

Shares Held: 1,374,974

Held Since: 01/07/2017

Share Category: Class Z — Accumulation (GBP)

Intermediaries must store shareholder information for at least 12 months after they become aware someone ceases to be a shareholder; hence data storage and retention requirements are to increase.

Proxy advisor transparency and reporting

Proxy advisors face several new European transparency obligations, including annual disclosure of their code of conduct, which essentially distils how closely they match national standards in this realm (provided, of course, those standards are in place) or explains why they have not established one. They must disclose details of their methodology, information sources, and procedures in place to ensure quality of voting recommendations, research, and advice. They must also report annually on their policies for preventing conflicts of interest and how they deal with any national-market differences. Given that similar requirements are in place in jurisdictions such as that of the U.S., albeit voluntary requirements rather than mandatory, the impact on globally active proxy advisors will be minimal in the short term.

Buy-side transparency and reporting

In line with other corporate governance requirements that have been introduced to Europe since the financial crisis, SRD compels asset managers to align their investment strategy and decisions with the risk profile and long-term investment requirements of their institutional investor clients. Both institutional investors and asset managers must be more transparent about their engagement with investee companies and about how they integrate shareholder engagement into their investment strategy. SRD indicates that this information must be reported annually and made available on the buy-side firms’ websites. These firms must also annually disclose voting behaviour and explain significant votes and their use of proxy advisor services. The directive introduces a comply-or-explain obligation around meeting these requirements.

Director remuneration and related party transactions

SRD grants shareholders the right to vote on companies’ remuneration policies and for those votes to be binding or advisory, which may incur additional requirements for policy analysis and assessment for the buy-side. It also requires that any material transaction, which is to be defined by national regulators, between a listed company and a related party must be announced and approved by the shareholders

SOURCE: AITE GROUP

and the board. Depending on national requirements, the announcement may also need to be accompanied by a report about the impact of the transaction from an independent third party, the board, or a committee of independent directors. These requirements will entail the production of much more data and reporting ahead of a vote and may create a significant burden on asset managers and investors in managing this information flow, particularly with regard to related party transactions. However, shareholders will welcome the increased transparency and their additional rights regarding what is today probably the most contentious corporate governance issue—executive remuneration.

Meeting announcements and voting

SRD introduces the requirement that intermediaries must transmit general meeting agenda and voting information “without delay” to shareholders in a standardised format, though it will be up to the EC to provide more clarity on what such a format should look like. This could result in amendments to current SWIFT message formats, which must be supported by intermediaries and proxy advisors, and this will incur costs. The voting information must be transmitted via the potentially long chain of intermediaries, and national regulators may prescribe a mandatory deadline for submission of this information.

The prescription of standard deadlines may lead to heightened vote processing peaks from current levels. If vote information must be transmitted immediately, then intermediaries cannot wait until a cut-off deadline and must introduce intraday (at the very least) processing support. Broadridge estimates that, on average, 20% of ballots have an amendment to the share position on any given day, though if there is significant volatility, the volume of amendments increases. Moreover, on average, about 0.5% of voted ballots are re-voted in a different direction on any given day.

After implementation of SRD, the frequency of instruction reporting may be different (rather than in batches), and amendments will likely be submitted throughout the voting period. A significant volume increase is likely to occur for instructions and amendments—perhaps even resulting in 200% more instructions sent than votes and around a 150% increase in the number of messages sent compared to before SRD’s adoption. Impacts will vary from market to market, however, as certain countries have established market

practices around mandatory record dates. In markets with record dates occurring closer to the meeting date, custodians will need to keep track of votes submitted and continue to adjust the eligible position associated with the votes. In markets for which votes are placed at omnibus level, the omnibus vote will need to be continually recalculated and resubmitted.

The mandatory format is anticipated by industry participants to be ISO 20022 for these instructions. A securities services respondent notes that though these transparency changes may lead to higher levels of straight-through processing in the long term, they will require significant intermediary investment to support the adoption of ISO 20022 messages (if they are mandated). SRD as it stands does not indicate which party will carry the costs of these technical and technology changes.

A custodian respondent indicates that the amount of information that must be transmitted immediately is concerning because of the lack of regulatory clarity on whether it also encompasses post-meeting announcements, which can be numerous. The EC and national regulators will need to confirm the level of information that must be passed on to shareholders. Depending on the level required, an operational headache is potentially awaiting intermediaries that currently have processes that can support voting information transmission (albeit they will need to be adjusted to new volume requirements) but cannot support other data items in the same standardised and immediate manner. The depth of the data and the mechanism for information submission will be key questions to be answered by the regulatory technical standards.

What to do with all that data?

Intermediaries’ clients will also be negatively impacted if they receive a deluge of data that is not submitted in an industry-standard manner and varies from country to country – this being in addition to the voting data that they already receive. A custodian respondent explains that multiple sources of information in different formats would overwhelm clients, and if references to previous announcements are not consistent, the data will be unusable. On this point, the directive is currently unclear about what a custodian or intermediary should do in the case that a shareholder specifically requests not to receive proxy notifications or it does not request that the custodian provide a proxy service.



A securities services respondent indicates that issuers and their agents may need to reconsider and change the very fundamentals of the issuance process from the full legal paper-based document in favour of a more electronically compatible message to improve straight-through processing treatment from the issuer announcement onward. The transmission of potentially sensitive client information is of great concern to intermediaries, especially in the current era of heightened cybersecurity awareness. National data privacy requirements will likely mean reporting firms should invest further in encryption technology. Depending on which party assumes the responsibility to support these new requirements, technical investments will need to be made to custodians' systems directly, or they must set up data validation processes to check the data being supported by their proxy services provider.

Pricing transparency and costs

A new era of proxy services pricing transparency will likely stem from SRD, because intermediaries will need to disclose their fees in relation to these services. Currently, the service provider and its client must determine the bundling of proxy fees into custody fees. As under the Markets in Financial Instruments Directive, this is likely to have knock-on effects for the industry via the potential unbundling of these various services and the resulting pressure on pricing. SRD stresses the need for "non-discriminatory and proportionate" fees, which may be challenging to support in a cross-border

environment in which different requirements are in place in different markets. If some regulators decide to directly prohibit fees for proxy services, these firms' business models must be completely revamped to take into account the changes.

A custodian respondent notes that the initial draft of SRD included the outright prohibition of proxy service fees altogether, but the EC received industry feedback about the negative impact that this move would have on the industry and made the requirement discretionary. Such feedback is important in influencing the future shape of national regulations.

No fees for disclosure allowed

Another challenge is that SRD indicates European member states can prohibit intermediaries from charging any fees for the cost of changes related to disclosure, which means that if regulators decide to mandate this, intermediaries must absorb all compliance costs rather than passing a percentage through to clients. If the national regulator is more lenient, these intermediaries can pass through certain costs, but SRD specifies that they must be proven to be proportionate to the cost of offering the service. Intermediaries, therefore, have the prospect of paying for the full cost of transparency requirements in certain jurisdictions and providing an audit trail of operational costs (and facing questions about any inefficiencies) in others.

CONCLUSION: NEXT STEPS

In many ways, SRD seems to differ from the general agenda of the European regulators over the last few years in harmonising market practices. By allowing a significant amount of leeway for national regulators to interpret and transpose the directive, the EC is potentially enabling shareholder voting to become less standardised compared to areas where cross-border standardisation is improving, such as settlement.

The industry needs to actively engage with the regulatory community to ensure that this divergent outcome is avoided. The EC has established an expert group to provide feedback on the impact and implications of SRD and is looking for interested and affected parties to ensure that its recommendations are in line with industry norms and market practices. As custodians that have already engaged with the EC indicate, the regulator has taken on board industry feedback already and is open to recommendations for the Level-2 implementing text, which is important in ruling out 27 different versions of SRD's requirements.

All firms must bear in mind the calendar for transposition and the deadline of June 2019. Changes that will likely require process and technology investment include the following:

Issuers and registrars:

- Standardisation of meeting announcements and provision of vote confirmation

Institutional investors and asset managers:

- The requirements for analysis on director remuneration and related party transactions could cause a significant data burden on asset managers and investors.
- Transparency requirements are unavoidable, and, as well as annual reporting, these firms will need to gather and publish corporate governance information—investment strategy and remuneration data—on their websites. Much of this data is likely not tracked by smaller firms in a consistent manner and may not be easily aggregated.
- Voting information must be recorded and reported in a comprehensive and consolidated fashion.

Intermediaries:

- These firms could face the brunt of the costs of SRD implementation, given the regulatory intent to prevent intermediaries from passing on costs to their clients. Proxy costs are sometimes bundled as part of a custody fee, but this may have to be re-evaluated in future.
- The potentially significant increase in voting (and supporting) data transmission will require intermediaries to assess their current workflows to either support directly or validate the processes of a service provider partner.
- Firms will need to keep a close watch on national-level requirements for the adoption of specific identification standards and data items for shareholder transparency requirements.

Proxy service providers:

- Proxy service providers face both opportunities and challenges in the market because of SRD's implementation—these firms may be able to deliver new services to help their intermediary partners support requirements such as vote confirmations, but they will have to invest to support these new services.

SRD is driving greater transparency in corporate governance and the shareholder voting process, and it is enabling better informed voting decision-making by shareholders. These are laudable and timely objectives, and the EC has recognised that they will not be achieved without regulation.

Now is the time for firms to review the impact of the Shareholder Rights Directive on their business and on their clients, examine their state of readiness and engage with industry authorities and other constituents as required.

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Global and Local Proxy Management

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To engage in further industry dialogue relating to the Shareholder Rights Directive, or for more information about Broadridge's proxy management and corporate governance services, please email global@broadridge.com or call +44 (0)20 7551 3000.

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