THE IMPACT OF THE EUROPEAN SHAREHOLDER RIGHTS DIRECTIVE II ON THE INVESTMENT FUND INDUSTRY

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I. THE SHAREHOLDER RIGHTS DIRECTIVE II : A BRIEF INTRODUCTION

The objectives of the European Shareholder Rights Directive II (**SRD II**)[1] are very ambitious: remedying the shortcomings of traditional corporate governance models that became apparent during the global financial crisis, i.e. excessive short-term risk borne in many cases by managers, inadequacy of the level of monitoring of investee companies and of the engagement of institutional investors and asset managers and undue focus on short-term returns.[2]

Falling within the scope of the European Commission's Action Plan on European company law and corporate governance launched in December 2012,[3] the SRD II seeks to encourage long-term shareholder engagement and to increase transparency between companies and investors at all levels. In order to achieve this goal, the SRD II introduces new requirements with regard to: (i) the identification of shareholders, the transmission of information and the facilitation of exercise of shareholder rights, (ii) the transparency of institutional investors, asset managers and proxy advisors, (iii) the right to vote on the remuneration policy, and (iv) the transparency and approval of related party transactions. More specifically, it provides that listed companies have the right to identify their shareholders with the objective of engaging in direct communication with the investor. For this purpose, intermediaries are required to communicate in a standardised and timely manner the relevant information concerning shareholder identity and to facilitate the exercise of rights by shareholders, including the right to participate and vote in general meetings. The SRD II also provides that listed companies must establish a remuneration policy as regards their directors and that shareholders have the right to vote on such remuneration policy at the general meeting. Material transactions between listed companies and a related party are subject to prior approval by the management body as well as to public disclosure requirements. Furthermore, institutional investors and asset managers are required to develop and publicly disclose their engagement policies as well as the implementation of such engagement policies.

Given the framework described above, this analysis aims at identifying the impact of the SRD II on the investment fund sector, especially in Luxembourg due to its importance as an international financial centre and its success in attracting asset managers and institutional investors globally. It focuses on identifying which of the players typically involved in the operations of an investment fund are likely to be impacted by the new requirements, taking into account the Luxembourg implementing law of 1 August 2019[4] (**Law**).[5]

II. INVESTMENT FUNDS AS ISSUERS OF SHARES

The SRD II addresses 'companies which have their registered office in a Member State and the shares of which are admitted to trading on a regulated market situated or operating within a Member State'.[6] In this regard, it is worth highlighting that the Law refers to companies 'under Luxembourg law whose shares are ad-

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, OJ L 132, 20.5.2017, p. 1–25.
2. See recital (2) of the SRD II.
3. European Commission, Press Release: Commission plans to modernise European company law and corporate governance, Brussels, 12 December 2012, IP/12/1340, https://europa.eu/rapid/press-release_IP-12-1340_en.htm.
4. Law of 1 August 2019 amending the law of 24 May 2011 concerning the exercise of certain rights of shareholders in general meetings of listed companies aiming at implementing the Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending the Directive 2007/36/CE as regards the encouragement of long-term shareholder engagement, available in French in Memorial A, N° 562, 20 August 2019.
5. The reference is to the consolidated text of the law of 24 May 2011 on the exercise of certain rights of shareholders in general meetings of listed companies and implementing 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, as amended by the law of 18 December 2015 (implementing Directive 2014/59/EU) and the law of 1 August 2019 (implementing Directive (EU) 2017/828).
6. Art. 1(1) of the consolidated text of the 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, as amended by the SRD II (**SRD**). The text is available as a documentation tool at the following link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02007L0036-20170609.

mitted to trading on a regulated market',[7] without any reference to the location of such regulated market. To lift any doubt, the last paragraph of Article 1(1) of the Law specifies that the Law is also applicable to 'those companies whose securities are traded on a market of a non-Member State, which is regulated, operates regularly, is recognised and open to the public, and which, by an express provision in their articles, have declared this law applicable'.[8]

The relevant companies, as issuers, are required to provide certain information to their shareholders before each general meeting and to facilitate the exercise of shareholder rights.[9] Furthermore, issuers must establish a remuneration policy as regards their directors.[10] It is worth mentioning that the SRD II introduces the right of shareholders to vote on the remuneration policy at the general meeting (the so-called 'say on pay' principle). Such vote may have a binding or an advisory nature.[11] The Law has opted for an advisory nature.[12] Notwithstanding the foregoing, the articles of association of the relevant issuers may provide that such vote is binding.[13]

The SRD II allows Member States to exempt from its scope of application: (i) UCITS within the meaning of Article 1(2) of Directive 2009/65/EC of the European Parliament and of the Council (**UCITS Directive**), (ii) collective investment undertakings within the meaning of Article 4(1)(a) of Directive 2011/61/EU of the European Parliament and of the Council (**AIFMD**) (i.e. alternative investment funds – **AIFs**), and (iii) cooperative societies.[14] Luxembourg opted for such exemption pursuant to Article 1(2) of the Law.

This means that investment funds are not concerned by the SRD II as issuers of securities. Even if investment funds have their shares traded on a regulated market, they are not subject to the above-mentioned obligations regarding *inter alia* the identification of their shareholders, the transmission of information and the facilitation of exercise of shareholder rights by their shareholders.

Notwithstanding the foregoing, the relevant exemption does not cover the transparency obligations laid down in chapter Ib of the SRD II[15] and in the corresponding chapter 1*ter* of the Law for institutional investors and asset managers.[16] Pursuant to the relevant provisions, institutional investors and asset managers are subject to transparency obligations with respect to their investment in shares traded on a regulated market. The rationale behind this choice is the consideration of the key role played by institutional investors and asset managers with regard to the corporate governance, the strategy and the long-term performance of listed companies.[17]

III. INVESTMENT FUNDS AS INVESTORS IN SHARES

While UCITS and AIFs are excluded from the scope of application of the SRD II as issuers of shares, the SRD II may nevertheless affect them in their capacity as investors in shares. In the context of the investment by an investment fund in a target company having its registered office in a Member State and the shares of which are traded on a regulated market, the relevant target company (directly falling within the scope of the SRD II) has the right to identify the investment fund as its shareholder. Furthermore, in case the investment fund is investing in a target company using intermediaries, the target company may request the intermediaries to communicate, without delay, information regarding the investment fund.

IV. ASSET MANAGERS

Asset managers within the meaning of the SRD II and the Law, which transposes quite literally the SRD II, are MiFID investment firms as defined in point (1) of Article 4(1) of Directive 2014/65/EU (**MiFID**) providing portfolio management services, authorised AIFMs, UCITS management companies (**ManCos**) and self-managed UCITS (**SIAGs**).[18]

The transparency obligations apply to them 'to the extent that they invest in such shares on behalf of investors'.[19] Since the term 'investors' is not further defined, the asset managers falling within the scope of the SRD II are those that invest in shares traded on a regulated market on behalf of 'any client or fund, regardless of whether the client was established in the EU and regardless of whether a

7. Art. 1(1) of the Law.
8. *Ibid.*
9. Art. 3b and 3c of the SRD and Art. 1*ter* and 1*quater* of the Law.
10. Art. 9a of the SRD and Art. 7*bis* of the Law.
11. Art. 9a(2) and (3) of the SRD.
12. Art. 7*bis*(2) of the Law.
13. Art. 7*bis*(3) of the Law.
14. Art. 1(3) of the SRD.
15. Art. 1(3a) of the SRD.
16. Art. 1(2) of the Law.
17. See recital (15) of the SRD II.
18. Pursuant to Art. 2(f) of the SRD, 'asset manager means an investment firm as defined in point (1) of Article 4(1) of Directive 2014/65/EU that provides portfolio management services to investors, an AIFM (alternative investment fund manager) as defined in art. 4(1)(b) of Directive 2011/61/EU that does not fulfil the conditions for an exemption in accordance with Article 3 of that Directive or a management company as defined in point (b) of Article 4(1) of Directive 2009/65/EC, or an investment company that is authorised in accordance with Directive 2009/65/EC provided that it has not designated a management company authorised under that Directive for its management'. See also Art. 1(6) of the Law.
19. Art. 1(6) of the SRD and Art. 1(5) of the Law.

fund has any EU investor, whether institutional investor or otherwise'.[20]

Based on the assumption that transparency has a positive impact on investor awareness, investment decisions by ultimate beneficiaries, dialogue between companies and shareholders, shareholder engagement and accountability to stakeholders and to civil society,[21] the SRD II makes asset managers develop and publicly disclose their engagement policy and its implementation.[22] Both must be available free of charge on the asset manager's website.[23]

The content of the engagement policy is expressly identified by the SRD II and the Law as comprising the following aspects: integration of shareholder engagement into their investment strategy, monitoring of investee companies on relevant matters, conduct of dialogues with investee companies, exercise of voting rights and other rights attached to shares, their cooperation with other shareholders, communication with relevant stakeholders of the investee companies and management of actual and potential conflicts of interests in relation to their engagement.[24]

The report illustrating the implementation of such engagement policy, to be published on an annual basis, should include a general description of voting behaviour, an explanation of the most significant votes and the use of the services of proxy advisors and a public disclosure of how they have cast votes in the general meetings of companies in which they hold shares. In this respect, it is expressly foreseen that votes that are insignificant due to the subject matter of the vote or the size of the holding in the company may be excluded by such disclosure.[25] It is worth mentioning that pursuant to recital (18) of the SRD II, investors should set their own criteria regarding which votes are insignificant and apply them consistently.

An exemption from the aforementioned engagement policy is possible only if there is a clear and reasoned explanation for non-compliance and provided that this latter is publicly disclosed. Neither the SRD II nor the Law identifies any reason/criterion for such exemption can be based. The EFAMA Stewardship Code,[26] which was updated in 2017 with the aim of being a reference document for asset managers seeking to comply with the SRD II and in particular with its Article 39 regarding engagement policy, does not provide any guidance either in this regard. The delegation of portfolio management and the existence of an engagement policy at the level of the delegated portfolio manager could potentially be regarded as a sufficient justification.

V. INSTITUTIONAL INVESTORS

Within the meaning of the SRD II and the Law, institutional investors are life insurance companies and pension plans.[27] The transparency obligations apply to them 'to the extent that they invest directly or through an asset manager in shares traded on a regulated market'.[28] Despite the lack of clarity in the wording, it also includes 'situations where an asset manager invests on behalf of an institutional investor, either on a discretionary client-by-client basis or through a collective investment undertaking'.[29]

Institutional investors are subject to the same requirements regarding the development and public disclosure of an engagement policy and its implementation as described above in relation to asset managers.[30] In addition, institutional investors must also publicly disclose how the main elements of their equity investment strategy are consistent with the profile and duration of their liabilities and how they contribute to the medium and long-term performance of their assets.[31]

Furthermore, where an asset manager invests on behalf of an institutional investor, the latter must publicly disclose its arrangements with the asset manager and, in particular, the following elements: (a) how the arrangement with the asset manager incentivises the asset manager to align its investment strategy and decisions with the profile and duration of the liabilities of the institution-

20. Alternative Investment Management Association (**AIMA**), Shareholder Right Directive II – Scope and Requirements for EU and Non-EU Asset Managers, July 2017, p. 7. See also more recently: AIMA, AIMA Guidance Note. Shareholder Rights Directive II – Scope and Requirements for Asset Managers, September 2019, p. 7.
21. See recital (16) of the SRD II.
22. Art. 3g(1) of the SRD and art. 1*sexies*(1) of the Law.
23. Art. 3g(2) of the SRD and art. 1*sexies*(2) of the Law.
24. Art. 3g(1) of the SRD and art. 1*sexies*(1) of the Law.
25. *Ibid*.
26. European Fund and Asset Management Association, EFAMA Stewardship Code, Principles for asset managers' monitoring of, voting in, engagement with investee companies, first adopted on 6 April 2011, revised in 2017–2018, available on www.efama.org.
27. Pursuant to Art. 2(e) of the SRD, 'institutional investor means (i) an undertaking carrying out activities of life assurance within the meaning of points (a), (b) and (c) of Article 2(3) of Directive 2009/138/EC of the European Parliament and of the Council, and of reinsurance as defined in point (7) of Article 13 of that Directive provided that those activities cover life-insurance obligations, and which is not excluded pursuant to that Directive; (ii) an institution for occupational retirement provision falling within the scope of Directive (EU) 2016/2341 of the European Parliament and of the Council in accordance with Article 2 thereof, unless a Member State has chosen not to apply that Directive in whole or in parts to that institution in accordance with Article 5 of that Directive'. See also Art. 2(6) of the Law.
28. Art. 1(6) of the SRD and Art. 1(5) of the Law.
29. AIMA, Shareholder Right Directive II – Scope and Requirements for EU and Non-EU Asset Managers, *op. cit.*, p. 7.
30. Art. 3g of the SRD and Art. 1*sexies*(1) of the Law.
31. Art. 3h(1) of the SRD and Art. 1*septies*(1) of the Law.

al investor, in particular long-term liabilities; (b) how that arrangement incentivises the asset manager to make investment decisions based on assessments about the medium to long-term financial and non-financial performance of the investee company and to engage with investee companies in order to improve their performance in the medium to long term; (c) how the method and time horizon of the evaluation of the asset manager's performance and the remuneration for asset management services are in line with the profile and duration of the liabilities of the institutional investor, in particular long-term liabilities, and take absolute long-term performance into account; (d) how the institutional investor monitors portfolio turnover costs incurred by the asset manager and how it defines and monitors a targeted portfolio turnover or turnover range; and (e) the duration of the arrangement with the asset manager. If one or more of such elements were to not be included, a clear and reasoned explanation must be provided.[32]

Finally, asset managers must disclose, on an annual basis, to the institutional investor with which they have entered into the arrangements referred to above how their investment strategy and the implementation thereof complies with that arrangement and contributes to the medium to long-term performance of the assets of the institutional investor or the fund. Such disclosure shall include reporting on the key material medium to long-term risks associated with the investments, on portfolio composition, turnover and turnover costs, on the use of proxy advisors for the purpose of engagement activities and their policy on securities lending and how it is applied to fulfil its engagement activities if applicable, particularly at the time of the general meeting of the investee companies. Such disclosure must also include information on whether and, if so, how they make investment decisions based on evaluation of medium to long-term performance of the investee company, including non-financial performance, and on whether and, if so, which conflicts of interests have arisen in connection with engagements and activities and how the asset managers have dealt with them.[33]

VI. PROXY ADVISORS

Proxy advisors are defined as legal persons that analyse, on a professional and commercial basis, the communication of firms and, where relevant, other information of listed companies with a view to informing investors on their voting decisions by providing research, advice or voting recommendations that relate to the exercise of voting rights.[34]

Proxy advisors fall within the scope of the SRD II and the Law to the extent that they provide services to shareholders with respect to shares of companies which have their registered office in a Member State and which shares are admitted to trading on a regulated market situated or operating within a Member State.[35]

Proxy advisors are subject to certain transparency obligations in the sense that they must publicly disclose any reference to a code of conduct that they apply and report on the application of that code of conduct. In case of non-application of a code of conduct, a clear and reasoned explanation should be provided. Where proxy advisors apply a code of conduct but depart from any of its recommendations, they must declare from which parts they depart, provide explanations for doing so and indicate, where appropriate, any alternative measure adopted. In addition, proxy advisors are also required to disclose on an annual basis key information in relation to the preparation of their research, advice and voting recommendations.[36]

UCITS and AIFs, or their asset managers, frequently have recourse to the services of proxy advisors while investing in shares traded on regulated markets. As a result of the implementation of the SRD II, the relevant investment funds will be able to rely on the annual disclosures to be made by proxy advisors in order to assess the accuracy and reliability of the activities provided by the relevant proxy advisors.

VII. INTERMEDIARIES

Intermediaries are persons, such as investment firms, credit institutions and central securities depositaries, which provide the services of safekeeping of shares, administration of shares or maintenance of securities accounts on behalf of shareholders or other persons.[37]

The provisions of the SRD II are applicable to intermediaries, insofar as they provide services to shareholders or other intermediaries in relation to shares of companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State.[38] The Law also applies to intermediaries which have nei-

32. Art. 3h(2) of the SRD and Art. 1*septies*(2) of the Law.
33. Art. 3i of the SRD and Art. 1*octies* of the Law.
34. Art. 2g of the SRD and Art. 1(6) of the Law.
35. Art. 1(2) of the SRD and Art. 1(5) of the Law.
36. Art. 3j of the SRD and Art. 1*nonies* of the Law.
37. Art. 2(d) of the SRD and Art. 1(6) of the Law.
38. Art. 1(5) of the SRD and Art. 1(4) of the Law.

ther their registered office nor their head office in the EU when they provide the services referred to above.[39]

Intermediaries must communicate without delay to the investee company the shareholder identity.[40] Intermediaries must also transmit, without delay, to the shareholder the information which the company is required to provide to the shareholder, to enable the shareholder to exercise the rights deriving from its shares (or a notice indicating where that information can be found on the company's website).[41] Furthermore, intermediaries must facilitate the exercise of the rights by the shareholder, including the right to participate and vote in general meetings.[42] Moreover, intermediaries must publicly disclose any applicable charges for services provided and ensure that such charges are non-discriminatory and proportionate in relation to the actual costs incurred for delivering such type of services.[43]

Investment funds often do not invest directly in target companies whose shares are traded on regulated markets, but rather through intermediaries or chains of intermediaries. The new provisions aim to prevent such indirect holding structures from hindering shareholder engagement.[44] Based on the provisions of the SRD II, investment funds will now be able to rely on their intermediaries in order to obtain the information which the investee company is required to publish and to exercise their rights as shareholders in general meetings of the investee company.

VIII. SANCTIONS

The directors are jointly and severally liable for any damages resulting from the violation of their obligations under the Law.[45]

A director is defined in the Law as any member of an administrative, management, or supervisory body of a company as well as the chief executive officer and, if such function exists within a company, the deputy chief executive officer.[46] The relevant definition does not specify that the term 'company' is used within the meaning of a 'company having its registered office in a Member State and the shares of which are admitted to trading on a regulated market'. Therefore, it must be assumed that the term 'company', in this context, also includes other actors referred to in the Law, such as asset managers and institutional investors. Based on the above assumption, directors of asset managers and institutional investors are likely to be jointly and severally liable for any damages resulting from the violation of their obligations under the Law.

IX. OPEN ISSUES AND CHALLENGES

Given the recent nature of the new requirements and the lack of abundant market practice, it is currently difficult to assess the concrete impact of the SRD II and the Law on the investment fund industry. Furthermore, there are also some critical open issues and challenges that should be taken into account.

In case of delegation of portfolio management to a delegate based in the EU which qualifies as a MiFID investment firm, authorised AIFM or ManCo, the delegate itself falls within the scope of the definition of an asset manager and, as a consequence, within the scope of the SRD II. Nevertheless, it is unclear whether the transparency obligations apply only at the level of the delegated portfolio manager or at both the level of the delegate and the level of the AIFM, ManCo or SIAG which is delegating the portfolio management. The existence of an engagement policy at the level of the delegated portfolio manager could likely be regarded as a sufficient justification for an exemption of the delegating AIFM, ManCo or SIAG.

If the delegate is a third country entity and/or does not qualify as a MiFID investment firm, authorised AIFM or ManCo, the situation becomes more complex. Indeed, even if such entities are considered as outside the scope of the SRD II, it could be argued that the delegation of portfolio management should not lead to any bypass of the transparency obligations provided for by the SRD II. Therefore, when delegating the portfolio management to a third country entity, it would be in the interest of the relevant AIFMs, ManCos and SIAGs to contractually oblige the delegated entity to put in place an engagement policy and to comply with the relevant disclosure requirements.

An additional element of complexity is constituted by the overlap between the obligations set forth under the SRD II, on the one hand, and UCITS as well as AIFMD rules, on the other hand, in terms of transparency and voting rights strategy. Indeed, investment fund managers are already obliged under both the UCITS and AIFM regimes to report on investment activities, portfolio composition, turnover costs and conflicts of interests. Furthermore, UCITS ManCos and AIFMs are also required to develop an adequate and effective strategy for determining when

39. Art. 1(4) of the Law.
40. Art. 3a(2) of the SRD and Art. 1*bis*(1) of the Law.
41. Art. 3b of the SRD and Art. 1*ter* of the Law.
42. Art. 3c of the SRD and Art. 1*quater* of the Law.
43. Art. 3d of the SRD and Art. 1*quinquies* of the Law.
44. See recital (4) of the SRD II.
45. Art. 11*ter* of the Law.
46. Art. 1(6) of the Law.

and how voting rights attached to instruments held in the managed portfolios are to be exercised to the exclusive benefit of the UCITS/AIF concerned and its investors.[47] Therefore, a key issue for asset managers in the near future will be how to deal with the aforementioned overlap that could lead to an 'unnecessary duplication of duties for asset managers'.[48]

The development and implementation of an engagement policy require an investment in people and processes. Engaging with an issuer on a particular issue or theme may last months or years. This requires an extended commitment of skilled experts to monitor assets, prioritise issues for engagement and engage credibly and constructively. Many asset managers see their engagement with investee companies as a competitive advantage. However, some of these benefits accrue not only to the asset manager that incurs the costs of exercising engagement, but also to all other investors. As such, certain asset managers may not invest as fully as they otherwise might and instead 'free ride' on the engagement of others.[49]

Implementing an engagement policy means challenging issuers' strategies and decisions, influencing the corporate strategy to further the issuers' interests, engaging deeply with investee companies, closely monitoring and engaging with boards and management of investee companies. Asset managers of UCITS funds will have to assess how such implementation of an engagement policy is compatible with legal investment restrictions applicable to UCITS, pursuant to which a UCITS may not acquire any shares carrying voting rights which would enable it to exercise significant influence over the management of an issuing body.[50]

The willingness of asset managers to invest in the development and implementation of an engagement policy may also depend on the investment strategies which they pursue. Where asset managers hold fewer liquid assets, have less diverse portfolios and/or are unable to exit investments, there may be a greater incentive to use engagement policies as a tool to protect asset value. By contrast, actively managed funds investing in liquid securities may consider it preferable to sell down rather than deeply engage with investee companies.[51]

Index-tracker funds do not give the asset manager the choice whether or when to exit. The inability to exit investments increases the incentive to undertake engagement activities. On the other hand, passive investors can compete largely on the basis of lower fees, possibly increasing incentives to free ride on engagement benefits provided by others rather than incur engagement costs themselves.[52]

47. Art. 23 of the CSSF Regulation 10-4 of 24 December 2010, Art. 37 of the Delegated Regulation 231/2013 of 19 December 2012 and section 5.5.10 of the CSSF Circular 18/698 of 23 August 2018.

48. European Fund and Asset Management Association, EFAMA's Views on the European Commission's legislative proposal for a Directive amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement – 'Revision Shareholders' Rights Directive', October 2014, p. 2, available on www.efama.org.

49. Financial Conduct Authority (**FCA**), Building a regulatory framework for effective stewardship, Discussion Paper DP19/1, January 2019, p. 9, available on www.fca.org.uk.

50. Art. 48 of the Luxembourg law of 17 December 2010 concerning undertakings for collective investment.

51. FCA, Building a regulatory framework for effective stewardship, *op. cit.*, p. 24.

52. *Ibid.*, p. 24–25.