

The Regulatory Framework of Institutional Investors' Engagement with German companies

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Abstract: Decision-making shareholder rights are considered the touchstone of corporate democracy. By exercising these rights shareholders can express their will regarding the corporate policy and the management of important corporate affairs by the board of directors. Even though their exercise is optional for shareholders, 'the corporate governance framework is built on the assumption that shareholders engage with companies and hold the management to account for its performance'¹. Shareholder engagement entails the use of shareholder rights, including voting rights and cooperation with other shareholders, with the aim 'to improve the governance of the investee company in the interests of long-term value creation'².

Shareholders' base can be diverse ranging from retail investors to institutional investors, like pension funds, insurance companies, and sovereign wealth funds. The nature of institutional investors' obligations towards their end beneficiaries makes the EU regulator characterize them as long-term investors with 'an interest in engagement'³. However, at least up to the financial crisis of 2007-2008, it was evidenced that their engagement with corporate affairs was 'inadequate'⁴. Therefore, there have been regulatory initiatives in multiple jurisdictions aiming to enhance their corporate governance role by establishing engagement 'duties'. Such initiatives range from soft-law instruments, such as Stewardship Codes, to mandatory legal instruments, such as the Shareholder Rights Directive II (hereinafter: SRD II).

Stewardship Codes⁵ establish good practices for asset owners and asset managers⁶ regarding their interaction with investee companies. Stewardship as an investment approach is 'material' for both the end beneficiaries of institutional investors and for the investee companies. Stewardship means such as the 'active exercising of voting rights' can help end beneficiaries

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¹ European Commission, *Green Paper: The EU corporate governance framework* (COM 2011/0164 final), p. 3.

² *Ibid*, p. 11.

³ *Ibid*, p. 11.

⁴ 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, Recital 2, 15.

⁵ The first Stewardship Code was introduced in 2010 in the United Kingdom. For a list of stewardship codes visit: <https://www.ecgi.global/content/codes-stewardship>.

⁶ The terms institutional investors and asset owners are used interchangeably. Asset managers are investment firms that manage assets on behalf of institutional investors.

‘increase (their) long-term returns’ by ‘helping companies achieve sustainable economic growth’⁷. Compliance with these Codes happens voluntarily. If institutional investors decide to comply with stewardship rules, they have to report their engagement policy, including their voting policy, and their engagement activities, including their ‘most important’ votes⁸. These reporting requirements secure transparency and effective monitoring by the end beneficiaries. Transparency is essential for the growth of ‘a competitive market for stewardship’ which ‘could significantly improve corporate governance, with wider benefits for the economy and society’⁹.

SRD II aims at enhancing institutional investors’ and asset managers’ engagement under the assumption that ‘greater involvement of shareholders in corporate governance [...] can help improve the financial and non-financial performance of companies’¹⁰. It attempts to achieve this by obliging them to regularly publish information about their engagement policy, including their voting policy (art. 3g). Even though the law does not mandate institutional investors to engage with their companies, it is expected that the obligation to disclose their engagement policy will enhance the level of their engagement¹¹.

According to institutional economic theory, legal rules are among the institutions that affect human behavior. In this paper, we aim to map the rights and duties of institutional investors as shareholders of German companies based on SRD II and the applicable German law. Article 3g of SRD II was transposed in German corporate law with ARUG II¹² as article 134b AktG. No Stewardship Code has been adopted in Germany, although there have been guidelines published by DVFA in 2020¹³ following the recommendations of the EFAMA Stewardship Code¹⁴. However, stewardship code initiatives have influenced the rules adopted by SRD II and they might be applicable to institutional investors with their seat outside Germany. Therefore, we will refer to stewardship obligations provided in codes of jurisdictions other than

⁷ Swiss Stewardship Code (2020), Introduction, p. 4. Even though multiple definitions of stewardship can be found in the existing stewardship codes and literature, we choose to use the one used in the Swiss Stewardship Codes, as this is going to be among the regulatory initiatives that we will focus our research on.

⁸ Swiss Stewardship Code (2020), Principle 3.

⁹ FRC & FCA, *Building a regulatory framework for effective stewardship* (DP19/1, January 2019) para 3.11.

¹⁰ SRD II, Recital 11.

¹¹ Ibid, Recital 16: ‘Public disclosure of such information could [...] facilitate the dialogue between companies and their shareholders, *encourage shareholder engagement* and strengthen their accountability to stakeholders and to civil society.’

¹² Gesetz zur Umsetzung der zweiten Aktionärsrechterichtlinie (translation: German Act Implementing the Second Shareholder Rights Directive).

¹³ DVFA is the German Association of Professional Investors. You can find the DVFA Stewardship Guidelines at: <https://www.icgn.org/sites/default/files/2021-11/20200319%20DVFA%20Stewardship%20Guidelines%20v.2.pdf>.

¹⁴ Available at: https://www.efama.org/sites/default/files/files/EFAMA%20Stewardship%20Code_FINAL.pdf.

Germany that bind institutional investors who hold shares in German companies. We will focus on three Codes, the UK Stewardship Code, the Dutch Stewardship Code, and the Swiss Stewardship Code.

Besides analyzing the duties of institutional investors as shareholders, we will also analyze their rights as provided by German corporate law. We will do so aiming to evaluate the means that institutional investors have at their disposal to comply with their duties as shareholders of German public companies. We will focus on the rights whose exercise is perceived as active engagement with the investee companies. More specifically, we will analyze the right of shareholders to submit proposals or add items to the agenda of the general meeting. One distinctive example of German corporate law is the right of each shareholder to submit a counter-motion to a proposal submitted by the company's management (art. 126 AktG). We will further analyze voting rules (quorum and majority rules) and the obligation of the company to disclose information regarding the items on the agenda before the general meeting and the voting results after the general meeting.

The analysis of the regulatory framework is the first paper of our research on the effect of SRD II disclosure requirements on institutional investors' engagement. To do so, in a second paper we will collect data on institutional investor engagement in German companies before and after the adoption of art. 134b AktG. Our goal is to answer the following question: are disclosure requirements as provided in SRD II and Stewardship Codes an effective tool to influence institutional investors' engagement with investee companies?

Keywords: shareholder engagement, SRD II, Stewardship Code, institutional investors