ICGN
International Corporate Governance Network

ICGN Viewpoint

Brexit: what are the governance implications for the EU and the UK?

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A famous headline from 1930 in the UK's *Daily Mirror* proclaimed "Fog in Channel: Continent Cut Off." This alacrity regarding the separation between the UK and the Continent by fog takes on a longer term perspective when put into the context of Brexit—the UK's decision to leave the European Union. Brexit is an important geopolitical development, raising wide ranging issues that are political, social and economic in nature. This Viewpoint focuses specifically on implications of Brexit from perspective of corporate governance and responsible institutional investment. It explores the potential impacts both in the EU and the UK. [1]

A reflection on Brexit and corporate governance is inevitably speculative in some ways, as there is not a lot of fact to go on-- particularly since Brexit has yet to occur and we do not exactly know what it will look like. But it is possible to explore and anticipate the potential impact of Brexit, both in the UK and European Union. This is an important issue affecting ICGN members. Many ICGN members are based in the European Union, and almost all investor members of ICGN will have investment holdings in the UK and EU; moreover roughly half of ICGN members are Europe-based, with over 20% from the UK.

In the near term there is not likely to be immediate substantial change from a corporate governance perspective, and the UK will continue to have a strong influence on European corporate governance, both in general philosophy and in practice. Over time, however, the UK influence in Europe could diminish in ways that have negative impacts for corporate governance and institutional investors. At the same time the UK's own corporate governance model, based on shareholder primacy, may come under further scrutiny to the extent that investor expectations on companies are seen to encourage unduly short-term time horizons that may be to the detriment of long term sustainability.

UK as Ying to the Continent's Yang: best of times or the worst of times?

While the UK and Continental Europe share many common traditions and cultural links, there are also contrasting features that present different visions of corporate governance and the role of the company in society. In a broad context this is manifested in differing intellectual traditions, for example the British empiricism of philosophers Locke and Hume in contrast to the Continental rationalism of Descartes and Spinoza. Stemming from these philosophical groundings, and a bit closer to corporate governance, the British tradition of common law versus civil law on the Continent presents a contrasting legal framework with governance implications. This

[1] This Viewpoint on the political impact of Brexit follows a recent ICGN Viewpoint on the changing political landscape in the United States and its implications for corporate governance: https://www.icgn.org/governance-questions-posed-changing-us-political-landscape

may explain, at least in part, the widespread prevalence of widely held listed companies in the UK, in contrast to the common feature of controlled companies in Continental Europe. Moreover, the UK model of shareholder primacy is offset by a strong stakeholder focus on the Continent, which offers differing views of company purpose and the importance of shareholders.

Are these clashing and disruptive forces? Or do they provide a healthy dialectic and a higher level synthesis of perspectives? The mere occurrence of Brexit suggests that there are differing views on these questions, but there is concern by some investors on both sides of the Channel that a potential lessening of the UK influence in the EU corporate governance debate may have negative consequences, particularly in the area of minority shareholder rights. Institutional investors in European companies remain concerned about the potential for misalignment between the private interests of controlling shareholders (or in some cases state interests) with the interests of minority investors. The UK has traditionally served as a strong champion in Europe for shareholder rights and minority protections. Does Brexit therefore suggest a potential weakening of shareholder rights in Europe?

Near term: no radical changes

At least in the near term Brexit is unlikely to result in significant changes in European corporate governance. The current corporate governance framework in the EU carries a strong UK influence, with the focus on governance regulation through transparency and disclosure –rather than prescriptive requirements. Also following from influence from the UK, governance standards in Europe are largely framed through national codes (and no EU federal governance code), with a soft law “comply or explain” mechanism.

This influence is further reflected in the growing role of institutional investors throughout Europe, particularly through the development of stewardship codes in many markets to encourage responsible and active investment practices. Stewardship and engagement activity is building in many markets, and there is no reason to anticipate an immediate shift in institutional ownership of EU based companies post Brexit, at least in the near term. So the institutional investor base in European companies will remain a significant minority voice and provider of risk capital.

Also important is the latest round of major EU corporate governance legislation—the revised Shareholder Rights Directive (SRD II). This too suggests British “fingerprints” through the Directive’s emphasis on investor governance and stewardship, voting on remuneration and facilitation on the exercise of voting rights. While future waves of regulation may take European governance in different directions over time these UK influences in corporate governance practices and in SRD II should remain strong—at least for the foreseeable future.

Longer term fault lines

The current influence of the UK corporate governance model in Europe may continue to remain strong in a post-Brexit environment. However, there are potential fault lines that could emerge to lead to new policy outcomes and a shift in governance structures away from a UK-influenced model and towards a Continental model emphasising differing preferences. Two possible fault lines in the governance debate are as follows:

- **Voluntary codes versus hard law regulation.** The UK advocacy of voluntary governance codes over black law regulation of corporate governance practices draws from its common law heritage. It emphasises the benefits of flexibility and is underpinned by reluctance to hard wire prescriptive governance practices into law without a clear justification by evidence. The robustness of this approach hinges on the effectiveness of a comply or explain approach to code adherence, with market forces –investors in particular—intended to play the role of monitoring companies and intervening in cases where company explanations of code compliance may be unconvincing. The need for institutional investors to monitor companies on a comply or explain basis is particularly acute for widely-held companies that otherwise may not have strong external monitoring from a controlling shareholder. Otherwise they might remain “ownerless”.

  The relevance of comply or explain, on the other hand, takes on a different meaning in controlled companies, in part given that the opinions of minority shareholders may carry little weight vis-à-vis the governance preferences of controlling shareholders. This voluntary, soft law approach is not a natural fit in a civil law jurisdiction. It could come under pressure by EU regulators who question the practical effectiveness of comply or explain—and the desirability of investors serving as a market monitoring mechanism. Over time this suggests potential scope for more rule-based direct regulation in corporate governance, as befits more civil code jurisdictions.

  Direct regulation in the EU could potentially be introduced to a wide range of governance issues from board composition (such as diversity quotas for boards) to shareholder voting rights (introduction of differential ownership rights). However well-intentioned that hard regulatory interventions of this nature may be, they may not always work to the long-term interests of companies and institutional investors. This is particularly true to the extent that the institutional investor voice in corporate governance is diminished by additional black law governance regulation.

- **Differing models of governance and company purpose.** A shift away from a code based system of governance and the UK tradition of shareholder primacy could also lead in Europe to a governance model that is more stakeholder focused, placing lesser emphasis on the interests of shareholders and greater emphasis on the interests of employees, customers and society in a broader context. While the UK already incorporates the obligation for directors to consider stakeholder interests through Section 172 of its Companies Act, a stronger stakeholder focus in Europe could go much further. It could frame the role of the company more as a social construct than as a commercial construct. This then raises the question of in whose interests the company is being run. It potentially challenges the interests and legitimacy of a shareholder based governance model -- reflecting concerns that investor influences may be overly narrow and short term.

The Florange Act in France is a European example suggesting a different model of corporate purpose, one in which the interests of institutional investors are not high on the pecking order. It is a statist public policy to allow for the entrenchment of controlling interests of French companies through differential voting rights. This tactic effectively serves as a poison pill to inhibit the market for corporate control, under the auspices of promoting long term investment perspectives. This has met with considerable investor opposition[2], as it has the net effect of marginalising institutional investors – and is anathema to the aspirations of investor stewardship.

This French example speaks to the potential post Brexit challenges of achieving a sustainable equilibrium between the needs of institutional shareholders, controlling shareholders and stakeholders. To the extent there is a shift in the pendulum, it could shift away from institutional investors.

Implications for the EU

For investors in companies in the EU, governance concerns remain, in particular about minority shareholder rights in controlled companies. To the extent that Brexit were to lead over time to a weakening of institutional investor influence in corporate governance, investor protections would face ongoing threats and the influence of stewardship and engagement as market mechanisms could diminish. There remains cultural resistance to engagement with institutional investors in some important continental European markets, Germany and France, for example. Brexit in this context has the potential to retard, if not reverse, the current trend of investor stewardship. Many investors would find this unfortunate. In this context a key barometer of the institutional investor role in Europe will be the extent that investor engagement with companies and their boards continues to build—or not.

It is worth noting in this vein that the EU's Capital Market Union (CMU) initiative is virtually silent on corporate governance matters—even though one of the ambitions of this programme is to make European companies attractive to direct and portfolio investment outside the EU. While many investors are generally supportive of CMU there may have been a missed opportunity in CMU to place greater emphasis on governance reforms to better address weaknesses in minority shareholder rights. Related party transactions (RPTs), for example, are an important area of potential abuse by controlling shareholders, and many institutional investors believe that SRD II could have gone further in minority protections relating to RPTs.

Apart from SRD II, the EU does not appear to have a clearly defined policy agenda regarding corporate governance, though the European Commission is paying close

[2] See ICGN's recent Viewpoint on differential ownership rights and dual class share structures: https://www.icgn.org/differential-share-ownership-structures

attention to themes of sustainability and their relationship to governance. It is important that investor rights and protections are not lessened while there is an increased focus on issues such as climate change, income inequality and human rights.

Implications for the UK

Governance in the UK may have less direct immediate impact from Brexit, given the deep traditions of UK corporate governance. However it is noteworthy that the UK government is exploring through its recent Green Paper how the awareness and influence of stakeholders can be better introduced into the corporate governance process. This reflects a clear Continental influence and suggests the desire of UK policy makers to promote long term perspectives by both companies and investors. This trend towards long termism and stakeholder inclusion is likely to build, and may give rise to a greater clarification behind the legislative intent of Section 172 of the Companies Act-- where stakeholder concerns are introduced to director duties.

Longer term impacts of Brexit are less clear, but the influence of the UK as a capital market centre could come under challenge from Continental markets, potentially offering to listed companies a Continental governance model that differs from the standards set in the UK Corporate Governance and Stewardship Codes. Such a model could also weaken minority shareholder protections and place less emphasis on the role of institutional investors in corporate governance and stewardship.

Getting the balance right

Brexit presents a potential waypoint in the trajectory of corporate governance and stewardship in both Continental Europe and the UK. There are risks to investors that are posed by Brexit. First and foremost is the potential erosion of the rights and protections of minority shareholders at the expense of controlling owners and stakeholders.

But in addition to risk, there is also opportunity. A positive realisation of this opportunity requires the relevant parties in the European corporate governance ecosystem to find a sustainable equilibrium between the interests of shareholders, stakeholders and controlling owners of European companies. An outcome that results in an undue bias towards one of these parties at the expense of another is not likely to be steady state and stand the test of time. It is aspirational to seek a vision of corporate governance in which Continental and UK visions of corporate governance can coexist sustainably, supporting the collective interests of minority investors, controlling shareholders and broader stakeholders.

A common thread may rest in the vision for the long term. All market participants can be guided by an intergenerational perspective. This requires controlling shareholders and stakeholders to appreciate the need for minority institutional investors to generate sustainable returns on investment to support their fiduciary duties to their clients—who are typically members of pension plans or long-term savers. At a basic minimum this suggests that investors seek to achieve economic profitability in their investments – where companies at least cover the cost of risk adjusted capital.

At the same time this requires investors to appreciate the importance of stakeholder relationships in sustainable value creation. Cutting corners around stakeholder relations and exploiting externalities is not a sustainable solution, and investors must appreciate that the objective of companies is not to maximise shareholder returns in the short term, but rather to optimise shareholder returns while satisfying the legitimate needs of stakeholders—including employees, customers and society at large. In cases of controlled companies, both institutional investors and stakeholders should support the long-term stability that controlling owners can bring—as long as controlling shareholders respect the legitimate needs and rights of their investors and stakeholders.

All market participants should ultimately be guided by a long term approach to capital markets and purpose of finance. This purpose is to provide sustainable returns to providers of capital and to provide companies, as users of capital, with the means to invest in economic growth, jobs and promote social welfare. This "win-win-win" synthesis between institutional investors, controlling shareholders and stakeholders is not an inevitable outcome. It requires systematic attention and the aspiration towards a "trilectic" synthesis that reconciles legitimate long term interests of institutional investors, stakeholders and controlling shareholders. This is a vision that can and should seek to reconcile UK and Continental interests in a post Brexit environment.

Conclusion

As Brexit begins to unfold we will have a clearer sense of its implications on corporate governance both in the UK and on the Continent. However, we do not anticipate an immediate impact from Brexit on corporate governance on either side of Channel. The influence of UK governance standards is likely to remain high with EU market participants at least in the near term. Over time, however, different traditions and models of governance between the UK and the Continent could take form along several fault lines. These could include differing approaches to shareholders and stakeholders and a divergence from a code-based governance regime to one more clearly defined by law and regulation.

From an institutional investor perspective minority shareholder rights and protections are still a concern in Europe. This is under further risk with less UK influence in the EU, and it is also the case that enthusiasm for engagement and stewardship could be under threat in some markets. Over the longer term these dynamics could be detrimental from an institutional investor standpoint.

To avoid potential pitfalls it is important for the various actors in the EU and UK governance "ecosystem" to seek sustainable and aligned interests between minority investors, controlling investors, stakeholders and regulators. In this dynamic, it is key for institutional investors (asset owners and managers) to act as responsible stewards to contribute towards constructive and sustainable long-term governance outcomes. ICGN, for its part, is prepared to serve both as a voice of institutional investor interests and as a convening platform for dialogue with key market participants in this important debate.

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