DO CHANGES TO THE EUROPEAN COMMISSION SHAREHOLDER RIGHTS DIRECTIVE ON CORPORATE PAY ALTER SHAREHOLDERS' MORAL RESPONSIBILITIES?

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INTRODUCTION

This paper looks at the specific proposed amendments to European directive 2007/36/EC and 2013/34/EU, and evaluates as to how such amendments alter shareholders' moral responsibilities. To be responsible is here simply to be understood as being under an obligation, where an obligation is a requirement on an agent to either act or refrain from acting in a given way. In order to determine whether changes to the proposed directives alter shareholders' moral responsibilities the following analysis argues that we need to look at three factors: whether such changes do in fact alter the subject matter of shareholders' obligations, a closer look at the agent i.e. shareholders to whom the obligation is to apply and thirdly whether they do actually apply.

Section one of this paper introduces the reader to the proposed amendments by the European Commission and the UK Governments proposals. It also introduces the two specific ratios that will be analyzed in greater detail, namely the ratio between the lowest and highest paid in the corporate, and the ratio between the fixed and variable parts of senior management remuneration.

What an obligation is and particularly what a moral obligation can be said to be is presented in section two with the focus being on G. E. M. Anscombe's and S. Wolf's discussions on command theories and the force needed to turn something from being morally required to being a moral obligation.

More specific differences between the European and the UK proposals are discussed in section three. This is relevant in order to understand what it is that the two authorities hope to achieve from the proposed amendments, and also the different approaches as to what the role of shareholders have been and should be going forward. Here I also draw on statements by politicians to form a stronger picture of the two perspectives.

Combining the discussion on moral command theories and looking deeper into the two proposed ratios allows for an analysis as to how these two ratios may effect what is perceived to be the changed moral obligations of shareholders. Such an analysis is to be found in section four.

Yet this in itself is not sufficient to say that moral obligations in fact have changed. This cannot be determined before looking at what it means to be a shareholder (section five) and whether such moral obligations can truly be said to apply to such shareholders (section six).

My conclusion, which is presented in section seven, states that there are in fact changes to shareholder moral obligations and as such changes to their moral

responsibilities. However, what the changes are depends on what type of shareholder we look at. Institutional shareholders responsibilities are altered more than small private shareholders by virtue of having more control of corporate boards and existing moral obligations to their clients and beneficiaries as stated by the UK Stewardship Code and the EFAMA Code for External Governance. Furthermore, I go on to show that given that the definition of shareholders significantly depends on the formal agreements between the relationship shareholders have to corporates, and in the case of institutional shareholders to their investors, any considerable changes to their rights or obligations in fact changes the meaning of the term shareholder.

1. AMENDMENTS TO THE SHAREHOLDER RIGHTS DIRECTIVE

On the 9th of April 2014, the European Commission announced amendments to directive 2007/36/EC and 2013/34/EU in regards to long-term shareholder engagement (2014 European Commission). Such amendments include the introduction of mandatory and binding shareholder voting on corporate pay (2014 Press Release, European Commission).

The reason for introducing such changes were said to be found in the recent economic crisis, where shareholders were too often shown to support managers' excessive short-term risk taking and further did not sufficiently monitor the companies they invested in (2014 Press Release, European Commission).

In a statement Michel Barnier (2012 John O'Donnell), the European Commissioner in charge of regulation, further expressed that:

> There is mounting public anger at the widening gap between earnings of bankers and business executives and ordinary workers when many European economies are in recession and unemployment is high.

To encourage shareholder engagement and participation to control excessive short-term risk taking by managers and adjusting the widening gap in earnings, the European Commission are looking at two proposed ratios (2012 John O'Donnell) on which shareholders are to be made to make a decision on namely; the ratio between the lowest and highest paid in the corporate, and the ratio between the fixed and variable parts of the remuneration.

Neither is the European Commission alone in looking at such amendments to shareholder voting rights. In January 2012, the UK Secretary of State for Business, Innovation and Skills announced a package of measures to address failings in the corporate governance framework for executive remuneration (2012 Department for Business Innovation and Skills). Such measures including empowering shareholders and promoting shareholder engagement through enhanced voting rights.

1.1 THE MATTERS AT STAKE

By reviewing the two proposed ratios the European Commission are investigating whether to increase shareholder engagement in two very separate

matters. One, as mentioned above, is the excessive short-term risk taking by corporate managers, and the other seemingly the widening earnings gap in corporates.

1.1.1 RESPONSIBILITY FOR EXCESSIVE SHORT TERM RISK

A ratio between the fixed and variable parts of the remuneration directly relates to excessive short-term risk taken by corporate managers. Whereby fixed and variable parts of remuneration are used as a tool to motivate specific behavior and actions amongst corporate managers. By introducing a mandatory and binding shareholder vote on such a ratio the European Commission are extending shareholders' legal responsibilities and rights to include that of controlling excessive short-term risk. Shareholders here come under extended responsibility simply by virtue of the vote on the specific ration becoming legally mandatory. They will be seen as fulfilling their legal responsibilities provided they vote.

Whether the amendment leads to any extended moral responsibility is not yet clear. The moral responsibility angle seemingly being something in the specific shape of;

'Shareholders ought control excessive short-term risk taking by corporate managers working for corporates in which they invest'.

The basic assumption being that excessive short-term risk taking is something to be avoided. This is not to say that shareholders alone are to be held responsible in case of shortcomings, but they clearly share this responsibility.

What makes this specifically interesting in not simply whether excessive short-term risk taking is viewed as something morally wrong, something that will be addressed in a future paper, but what type of risk the European commission might be referring to.

One type of risk could simply refer to the increased operational risk. This would be an area that few would object to the shareholder having some form of control and engagement in, as it directly relates to the survival of the firm. However, by associating the need for changes to the directive with 'the wider financial crisis' (2012 Press Release, European Commission) and 'public anger' (2012 John O'Donnell) the commission seems to be implying that there is a further risk to the society as a whole that needs to be taken into account. The concept that shareholders are morally responsible for this further risk to society as a whole will face wider objection in the form of for example Milton Friedman (Friedman 1970) and his view on the social role of business.

Yet, the lack of clarity as to whether shareholder moral responsibilities have been extended does not solemnly find its roots in the uncertainty as to the type of risk that is at stake. As will be discussed in great detail in section two and beyond.

1.1.2 RESPONSIBILITY FOR CONTROLING THE WIDENING EARNINGS CAP IN CORPORATES

The idea of a mandatory and binding vote for shareholders in regards to the ratio between the lowest and highest paid in a corporate potentially has a greater impact on shareholders and their responsibilities. Even though the proposal only mandates shareholders to vote on a ratio as proposed by corporate management, this is not an area traditionally seen as coming under the remit of shareholders. The ratio between the lowest and highest paid in a corporate comes more under the topic of social fairness and justice, rather than best practice in a corporate governance sense. Such a topic is surely seen to come under the responsibilities of politicians and legislators rather than investors. Is it then possible for shareholders to be bound by such responsibilities, and would such a bind necessitate us to change our perception on what it is to be a shareholder?

2. OBLIGATIONS AND THEIR ROLE IN RESPONSIBILITY

To hold an agent responsible is for the sake of this paper equivalent of viewing an agent to be under an obligation. An obligation being a course of action that one is required or bound to take, given the acceptance of a set code or standard. In order to determine whether the European Commission's proposed alterations to the shareholder rights directive alters shareholders' moral responsibilities this section will look at the concepts of obligation in general and of moral obligation in more detail. What is meant by an agent to be under an obligation will be discussed further in section four. For now I will simply provide the following definition:

> Agent A is under the obligation to B, where to B is to act or refrain from acting in a given way, given that agent A exist, that there exists an obligation to B and furthermore the obligation to B necessarily applies to agent A.

The word obligation has its origin in the Latin 'obligare', deriving from the root 'lig', meaning tie or bind. The term was first found to be used in *Plautus*' (254-184BC) *play Truculentus* (Zimmerman 1:1996). The play describing the prostitute Phronesium's relentless manipulation of all men. The concept of obligation was first introduced into early Roman law as a means for the state to overcome the common practice whereby a wronged party would be entitled to privately execute his punishment on a wrongdoer. Such punishment more often than not ending up in the wrongdoer's death. Instead, obligation law enabled the state to force the wronged party to accept financial compensation for wrong. Hence, the earlier concept of obligation included a party that was under duty to pay and a party that had a right to claim compensation. If the wrongdoer were unable to pay then he would come to belong to the wronged party, usually in form of a slave (Zimmerman 6:1996). The slave being bound in chains, hence the term 'obligare'.

Obligations come in a multitude of forms; legal, moral, social, political etc. What predominantly sets them apart is the set code or standards on which they depend to enforce the requirement to act in one way or another. When looking at obligations I adapt a legal frame of mind in the sense that I view it as a voluntary or involuntary contract containing the following three; an obligatoriness i.e. a subject matter, an oblige i.e. an agent who is said to have a duty to perform and a defined bond that connects the agent to the obligation. This is more in line with English common law, where there is no place for a party that has rights unlike Roman law (Zimmerman 10:1996).

For the sake of this paper we are looking at a situation where a political body, namely the European Commission, is making an alteration to shareholders legal obligations by way of amending the shareholders rights directive. The main question being whether this effects shareholders' moral obligations. In order to deal with this question it is right to start with explaining what a moral obligation is.

2.1 MORAL OBLIGATION

Moral philosophy tends to look at moral standards as reasons for action (Pink, 6th Dec 2002). The idea being that for something to be morally commendable is in itself a justification for action. However, moral standards go beyond that of simply being reasons or justifications for actions in that they also come with the obligation to perform them. We are bound by our moral obligation to act or refrain from acting in a given way.

Let us take the ten commandments as an example instructing us to remember the Sabbath and respecting our parents, while refraining from idolatry, blasphemy, murder, theft, dishonesty, and adultery. These instructions are to guide the way we ought to live in virtue of being a good person. A virtue going beyond that of mere logical requirements or positive law. Given that you are of Jewish or Christian persuasion such instructions are to be seen as binding rules rather than trifling guidance. Rules that are to be followed irrelevant of circumstances and consequences. To be a good person you must not murder or commit adultery. Furthermore, it is not only that you must not murder because a good person refrains from such actions. The rule is further enforced by the fact that it is God who has instructed man not to murder, and man is under obligation to follow God's instructions. Such enforcement is then meant to motivate us to act in a given way.

Anscombe (Anscombe 1958) highlights how strongly such a Judaic/Christian conception of ethics is linked to law. Under such a conception a person either conforms to the law or is given the verdict of being a bad man. The force and motivation behind the moral obligation becomes that divine law requires conformity. Yet, for such divine law to exist there must exist a divine lawmaker both to set out what such law entails and to function as a motivating force. Only then can we explain how something can go from 'is' to 'ought' (Anscombe 5:1958). Anscombe here draws on Hume's idea that truth consists in either relations of ideas or matters of fact. Let us take the moral judgment that 'to

murder is bad' as an example. It may even be a fact that 'to murder is bad' (something Hume would profusely oppose, as he objects to the idea of moral judgments being facts in general). Let us then see this fact as something that 'is'. However, even such a fact could not motivate us to do anything in itself. We would for example need to not want to murder or not to do bad in order for such a fact to move us and thereby have an effect on our actions. Hume would refer to such a motivating force as a passion. Such a passion would fulfill one of the requirements of obligation, namely that it provides us with a motive to act. Passion of this form is not part of or directly related to the fact in question. It is a psychological state of mind. Furthermore, even if we do have such a passion to move us into action, then this still does not oblige us to do something – the 'is' has not turned into an 'ought'. An 'ought' that necessarily binds independent of circumstances and consequences, which is the second requirement of an obligation. You need a further force demanding conformity a divine lawmaker and judge to fulfill all the requirements of a moral requirement.

Yet, is it not the case that it would be wrong to murder irrelevant of God's existence? Wolf (Wolf 3:2009) further raises the question whether our obligation not to murder is also irrelevant of God as it is an obligation we have to each other. We have an obligation to society. However, the same challenges would apply if we wanted to support a social demand theory of moral obligation (Adams 1987)(Wolf 2009) instead of a divine demand theory. We would still need to show that there exists such a thing as a 'society', that such a society has the power to impose moral obligations on us, and that we can know what these are.

As we have seen from the above, Anscombe has presented a concept of moral obligation where it is incoherent to claim that something is morally obligatory unless one is assuming that one is obliged by *someone*. Wolf (Wolf 8-9:2009) provides us with a different approach to the concept of moral obligation, where she defends the idea that we are able to discern what is morally required from what is merely recommended without the necessary existence of an external authority. To do so she refers to the form in which we blame or hold individuals accountable for their actions as a source for differentiating between the required and the recommended. Wolf finds her source of this idea in the following quotes by Mill:

> We do not call anything wrong unless we mean to imply that a person ought to be punished in some way or other for doing it – if not by law, by the opinion of his fellow creatures; if not by opinion, by the reproaches of his own conscience. (Mill 47-48:1979)

Followed by:

> There are other things, which we wish that people should do, which we like or admire them for doing, perhaps dislike or despise them for not doing, but yet admit that they are not bound to do; it is not a case of moral obligation; we do not blame them, that is, we do not think that they are proper objects of punishment. (Mill 48:1979)

However, the sheer notion that something is morally required of us, need not equate to an obligation. Wolf provides us with the example of etiquette requires us to pass port to the left (Wolf 10:2009). We would still not be obliged to do so. What would be needed in order for there to be some obligatory bond is that what we mean when we say that morality requires X of us is in fact that *we* require X of us. This brings us back to the problem of who these *we* are.

Both Wolf and Adams (Adams 1987)(Wolf 2009) claim that this *we* should be viewed as society. And it is in virtue of societies demands that a morally required reason becomes morally obligatory (Wolf 16:2009). This is also the stance that I will take going forward in this paper. However, this still leaves a lot of issues to be dealt with, such as the need to know what society accepts of us in order to be obliged to act in a given way. Furthermore, it requires that we accept that society has this force and an understanding of what *this* society is. These challenges will be explored in more detail below when applied to the specific case of the European commission's recommended changes to the shareholder rights directive.

3. HOW THE UK APPROACH TO SHAREHOLDER RESPONSIBILITES DIFFERS FROM THE EUROPEAN APPROACH

The European framework for corporate governance mainly consists of individual national corporate governance codes and the Organisation for Economic Co-operation and Development (OECD) principles for corporate governance, which were first published in 1999. For the sake of this paper I will be referring to the 2004 OECD Principles for Corporate Governance, 2014 UK Corporate Governance Code and 2012 UK Stewardship Code.

What the three have in common is that they are principles or codes offering non-binding standards and good practices as well as guidance on implementation. These are the result of consultations with minister, private sector, labour, and civil society (OECD, 6:2004). Furthermore they are all based on a 'comply or explain' system in that the participants can choose to divert from the codes and still fulfil their responsibilities, provided that they explain why they have chosen to divert. While the corporate governance guidance's look to promote principles underlying an effective board and recommendations on their relationship to shareholders, the UK Stewardship Code is aimed at guiding investors on how to better exercise their stewardship responsibilities.

Yet, the European proposal for changes to the shareholder rights directive goes further than UK recommendations. Whereas the UK propose mandatory and binding voting by the shareholders, they do not go as far as requiring shareholders vote on the ratio between the lowest and highest-paid employees in the corporate and the ratio between fixed and variable compensation. However both are stricter than the regulations in the US where the Dodd-Frank financial reform law of 2010 requires shareholders have mandatory voting rights, but these are not binding, i.e. corporates can chose to ignore them.

This difference between the European and the UK approach can also be seen in the language used by officials. Both make clear that there have been 'failings in the corporate governance framework for executive remuneration' (2012 Department for Business Innovation and Skills) and, that the implementation of sound corporate behaviour can reduce the damaging short-term behaviour witnessed amongst European corporates. However they do seem to differ in their opinion as to what role shareholders have played in causing such behaviour and what responsibilities they should have going forward.

In interviews and press releases Michel Barnier, the European Commissioner has been quoted saying:

> Shareholders were too quick to support managers' excessive short-term risk taking and further did not sufficiently monitor the companies they invested in (2012 Press Release, European Commission).

> Today's proposals will encourage shareholders to engage more with the companies they invest in, and to take a longer-term perspective of their investment (2014 Financial Times).

> I support transparency and increased shareholder responsibility

The above indicates that the Barnier disapproves of the way shareholders have acted and that he views they should have increased responsibilities going forward. This is not the tone taken by the UK's Business Secretary, Vince Cable. He instead talks about the importance of empowering shareholders in order to help monitor companies going forward, as can be seen in his following statements:

> These proposals restore a clearer, stronger link between pay and performance, they reduce awards for failures, they promote better engagement between companies and shareholders and overall they empower shareholders to hold companies to account through binding votes (2014 Daily Telegraph).

> Good corporate governance is vital to creating the right environment for long-term, sustainable growth. Shareholders are at the heart of the UK corporate governance framework, so it is appropriate that we put more information and power in their hands (S Tolley 2012).

Yet this is not to say that the UK Secretary for Business is promoting a view that shareholders do not have the duty to monitor their investee companies or should not play a role in corporates' remuneration policies. Both are made clear in principles one and three of the UK Stewardship Code (Financial Reporting Council 2012). Indeed, institutional investors are also expected to publically report on their policies on the matter in accordance to principle two of the UK Stewardship Code (Financial Reporting Council 2012). Instead it would seem reasonable to assume that the reason the UK Secretary for Business is unwilling

to criticize investors is because he acknowledges the lack of power that shareholders have had to enforce their views. This will change with the proposed mandatory and binding voting rights on pay.

Perhaps this also plays a role in why the UK is not yet requiring shareholders vote on the ratio between the lowest and highest-paid employees in the corporate and the ratio between fixed and variable compensation. In the UK the Corporate Governance Code is very much a voluntary code, whose spirit rather than word needs to be followed. A combination of the preference for a voluntary approach and the fact that shareholders have not yet necessarily had the control mechanisms to fully cohere with the code makes it unnecessary at this point to impose further restrictions. There seems still to be hope that the proposed changes will be sufficient to motivate shareholder behaviour in the desired fashion.

Independent of these differences both Europe and the UK have drawn the conclusion that the voluntary corporate governance codes and principles as they stand have proven insufficient in driving desired behaviour and as such regulation is being put in place to make shareholder voting on pay legally obligatory to both shareholders and corporates.

4. MORAL OBLIGATIONS AS IMPLIED BY AMENDMENTS TO DIRECTIVE 2007/36/EC AND 2013/34/EU

In this section I will look at whether the proposed amendments to directive 2007/36/EC and 2013/34/EU should be viewed as moral obligations. To do so I first want to look closer at the proposed ratios. In section one I presented the two proposed ratios on which shareholders are expected to vote, one relating to the proportion of fixed versus variable pay and the other the ratio between the lowest and the highest-paid in a corporate. I claimed that given that it would become legally mandatory for shareholders to vote on the two ratios they would become legally obliged to do so. However, these ratios are being proposed not only in order to increase shareholders monitoring of their investee companies but to also reduce what politicians view to be damaging short-term risk taking (2014 Press Release, European Commission), help tackle public anger over pay deals (2014 Daily Telegraph) and curb the anger at the widening gap between earnings of bankers and business executives and ordinary workers (2012 John O'Donnell). All of which go significantly beyond simply being asked to vote. Instead shareholders will also be held accountable for how they vote, bearing in mind the changes that such votes are expected to have on corporate behaviour. Votes by which institutional investors can be judged, as they are already obliged to make both their voting and their policy on corporate governance issues public in accordance to principle six of the EFAMA Code for External Governance (European Fund and Management Association 2011) and principle six of the UK Stewardship Code (Financial Reporting Council 2012). A shareholder can now be judged to do the right or the wrong thing depending on the outcomes of such a vote. For this to be just, there needs to be a right or wrong outcome which

shareholders are expected to achieve. And these need to be clearly known by those that are to be bound by them.

Importantly, both the EFAMA Code for External Governance and the UK Stewardship Code make it clear that institutional investors' duties are to vote and act in the interests of its clients and/or beneficiaries. There is significant research looking at the damaging potential of short-term risk taking by managers as well as how to better overcome agency issues by aligning managers interests with that of shareholders via a mix of monetary compensational tools (A. Smith 1776) (A. Berle & G. Means 1932). Such views being widely held amongst academics, politicians and business it is understandable why voting on a ratio relating to the proportion of fixed versus variable compensation can serve the purpose of looking after the interests of institutional clients and beneficiaries. However, this does not explain what role shareholders have in tackling public anger over pay deals *if* the deals are in fact in the interest of investor clients and beneficiaries. If not, then shareholders would now seem to have both a legal duty and moral duty to vote against a corporate proposal. A vote the corporate is now legally bound to act in accordance with. Yet it is unclear as to whether this would be a new moral obligation as the guidance to focus on such matters already existed before the proposed amendments. More on this will be discussed in section six.

But why should a vote on the ratio between the lowest and the highest paid in a corporate be relevant to investor clients and beneficiaries? At first glance it does not. This is an issue of justice and fairness and not corporate performance. However the idea is that corporates would have to justify managers' salaries in comparison to the lowest paid and that this would should lead investors to 'put a break on the annual upward pay ratchet' (2014 The Daily Telegraph) Looking at numbers such as that the average FTSE100 CEO is now paid 130 times the average UK worker (2013 High Pay Centre) one can feel sympathy with politicians efforts to have corporates justify such differences. Yet, unless regulated, executives' pay should be based on the value they bring to the corporate and its shareholders. It is not clear that such value is best presented in the form of a ratio of the lowest and highest paid employee. As our codes of conduct stand, investors' responsibilities lie towards their clients and beneficiaries and not society as a whole. Hence if the CEO's *are* in fact creating value for a corporate worth such sums then shareholders should not be concerned with the multiple. Economic fairness per say is not a subject that is the responsibility of the shareholder.

The above in this section has been a discussion on the subject of matter in what may or may still not be a moral obligation. What is further important to look at is whether the European Commission is in itself in the position to either claim one thing or another to be right, and secondly if the commission has the required force that would bind us to act in the right way. Both of which are necessary for the subject matter to in fact become a moral obligation. Such an approach to moral obligation is consistent with the discussed views of Adams (Adams 1987), Anscombe (Anscombe 1958) and Wolf (Wolf) in section 2.1. As stated in that same section, I support that it is in virtue of societies demands that a morally

required reason becomes morally obligatory (Wolf 16:).

To summarize, Corporate Governance frameworks consist of required codes of conduct and laws. The codes discussed in this paper are aimed at guiding investors' behavior both in individual European countries and across Europe as a whole. In section three I showed the differences in approach between the European Commission and the UK proposals. Were the European proposals to go through they would also apply to the UK by virtue of the UK being a member of the European Union. Furthermore, such codes and laws would also apply to non-European owners of shares in European stocks. By 2011 22% of European Stocks were in fact owned by non-European investors (OEE 38:2012) and by 2012 53.2% of UK stocks were owned by non-UK investors (Office for National Statistics 1:2013). The European Commission, being representatives of a democratically elected European Parliament have the legal right to set regulations that effect all corporates registered within their borders and their shareholders. Being a representative of a democratically elected Government they further have the obligation to represent the views and needs of that Government's people. Given that the proposed amendments to the shareholder directive are the results of significant consultations with representatives from a wide range of society I would claim that such proposals on the whole are a fair reflection of the views and needs of those people. Furthermore, its people have voluntarily accepted the European Union as an institution and society, as the individual states made a conscious choice whether to be part of this union or not. When doing so we, the European people, also accepted that there would be instances when the wider union will overrule our national interests and views. And again this is something that we as a majority have accepted when setting up the regulations for how this union should operate. As such the European Commission does have the power to impose moral obligations on us.

But the question still remains as to whether these subject matters are in fact moral obligations or moral requests given that none of the European Corporate Governance and Stewardship codes are a:

> Rigid set of rules. It consists of principles and guidance. The principles are the core of the Code and the way in which they are applied should be the central question for the institutional investor as it determines how to operate according to the Code. The guidance recommends how the principle might be applied (Financial reporting council 4:2012).

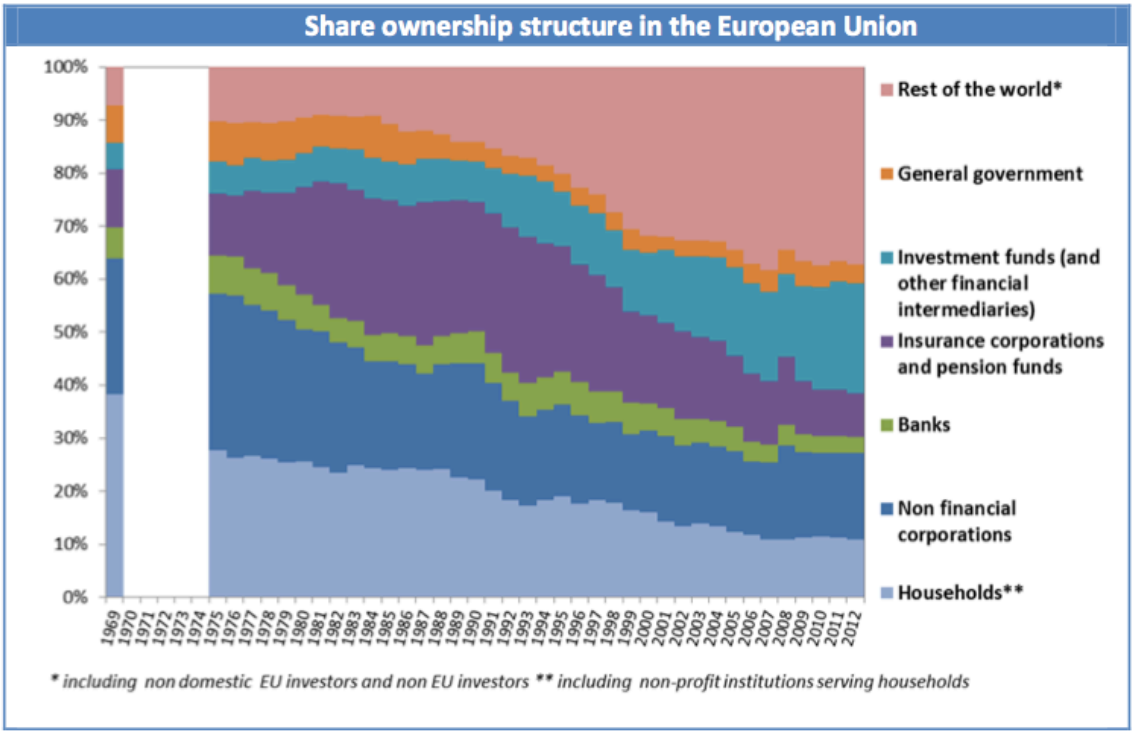
Perhaps the principles are not individually rigidly required to be followed, but the spirit of the code as a whole is. The moral obligation being that as an institutional shareholder your duty is to do right by your clients and beneficiaries irrelevant of the circumstances. And if the pressure of wider society or shareholders own conscience does not sufficiently bind them to act in the spirit of that code, then the political authorities across Europe have clearly shown that they are willing to bind shareholders to it by law.

Yet, even if we agree that the European Commission have the required force to demand a given behavior or 'obligatoriness', we also need to look at the agent who is said to have a duty to perform or 'the oblige' before drawing any

conclusion about their responsibilities. The section below will therefore look at what a shareholder is.

5. SHAREHOLDERS AS OBLIGES

A shareholder is simply an individual, organization, or company that legally own share(s) of stock in a joint-stock company. The below graph shows how the mix of the three has changed over the last forty years, making legal persons rather than purely natural persons the most dominant group of shareholders.



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Given that the core of the definition of 'shareholder' involves a person that has entered a legal relationship with a corporate, the explanation to *what a shareholder is* most often evokes replies predominantly focusing on the rights and duties that come with being a shareholder. The most common of those involving the right to receive dividends as determined by the board of directors, the right to vote for members of the board of directors and receiving their fair share of the residual value in cases of corporate wind down. The specific rights that shareholders have are further stated in a corporate's articles of incorporation and bylaws

If attempting to look at shareholders from an ontological perspective then what there is or what exist are a person (legal or natural), a corporate and a contract between the two. Secondly we have the most general features here being rights and duties and the relationship between the person and the corporate in which they invest.

Because a shareholder is in itself a legal concept, and as the law is simply a collection of rights and duties, then any major changes in the rights or duties of shareholders will in fact redefine what it is to be a shareholder. As we see from the above graph there are already different groups of shareholders: households, investment funds, insurance companies etc. However, this is not simply saying the same as that there are males and females, both of which are human and simply have different physical characteristics. In the case of shareholders the different types not only have different characteristics, such as being more or less able to effect a corporate because of their size, but also come under different groups of rights and duties. As such for example the duties described in the UK Stewardship Code and the EFAMA Code for External Governance only apply to Institutional Shareholders. It is also this group of shareholders whom are the main target of the proposed amendments by both the European Commission and the UK authorities. For the remainder of this paper I shall therefore differentiate between private shareholders and institutional shareholders when looking at their responsibilities.

For reasons of simplification I have chosen to treat all institutional shareholders as belonging to the same group, although there is clear diversity amongst pension funds, mutual funds, sovereign funds, hedge funds etc. One thing they all do have in common and that is critical for my assessment is that they are all legal persons. As such we need to ask the question whether they can ever be seen to have moral obligations, as the traditional concept of a moral agent does not involve legal agents. Without going into a deeper discussion on the matter I refer to my paper titled *Corporations and the sins of their forefathers* (Smith 2013) where I support List and Pettit's argument that corporates can in fact be seen as moral agents. However, this is only true in their limited role as enactors of the corporates' deeds. This is where members' and corporates' responsibilities overlap and where simultaneously exercised control occurs. The corporate is responsible "given the decisions it licenses and the procedures by which it channels those decisions," (C. List & P. Pettit. 166:2013) while the members are responsible for implementing such decisions. Without such simultaneous contributions, no actions could be performed in the name of the corporate. This is the situation that occurs amongst larger institutional investors, where not only would there be different individuals possibly buying the shares, to voting on the corporate proposal to externally declaring the policy on which this is done, but all the underlying often simultaneous occurring processes are partly beyond the control of the individuals themselves.

Given the above view on what it means to be a shareholder, and given my acceptance in section four regarding the European Commission and its right to impose moral demands the last piece of puzzle relates to what is required for shareholders to be bound by this specific demand. In section two I stated that my understanding of what it means to be under the obligation to act in a given way is the following:

Agent A is under the obligation to B, where to B is to act or refrain from acting in a given way, given that agent A exist, that there exists an obligation to B and furthermore the obligation to B necessarily applies to agent A.

The following section will discuss whether the moral obligations that are indicated by the proposed amendments to the shareholder rights directive can truly be said to apply to shareholders.

6. THE DEFINING BOND BETWEEN SHAREHOLDER AND OBLIGATION

As it stands it can be said to some extent that a moral obligation goes beyond and agents will and desires, for a moral obligation can be forced upon an agent. If an agent accepts an authorities right to demand us to perform in some fashion then we may for example be obliged to not commit adultery simply because so commanded and not because we do not want to commit adultery. A stricter requirement than mine might claim that we are morally obliged irrelevant of whether we even accept such authority, for example God's authority, because we remain under obligation simply by virtue of being human. Supporting either claim is sufficient to support that a moral obligation applies to an agent irrelevant of will and desires of the type mentioned above.

However, we are not inclined to accept that an agent is morally obliged to perform a given act if they are not capable of doing so. In other words, whether an agent can be said to be under obligation to act in a given manner is partly determined by her capacity to act in that way. I am not here referring to the strict sense of control that Strawson (G. Strawson 1:1993) speaks of when arguing for the basic case of free will, the central idea being that:

1. Nothing can be causa sui - nothing can be the cause of itself.

2. In order to be truly morally responsible for one's actions one would have to be causa sui, at least in certain crucial mental respects.

3. Therefore nothing can be truly morally responsible.

Instead I am referring to a simpler form of control. For example, we cannot be expected to vote if we do not have the right to vote. We need such rights in order to enable us to vote. It would be pure madness to claim that we are under the moral obligation to vote by virtue of being citizens, if we did not have the right to vote.

It is this type of control that becomes relevant when assessing whether shareholders can be said to be under any new moral obligations by virtue of the proposed amendments to European directive 2007/36/EC and 2013/34/EU. By proposing that shareholders have mandatory and binding voting rights on pay it implies that shareholders can now, at least if part of a majority, more likely affect outcomes. I say more likely, because where as a corporate could previously choose to adapt to the wishes of shareholders in relation to pay, they are now bound to act in accordance to those wishes. In other circumstances corporates would not even offer shareholders the chance to vote on the issue of pay as such votes were not mandatory. Provided the amendments go through, European corporates will be legally obliged to have such votes every three years, provided that no significant changes have occurred in between, in which case they will have to provide for annual voting opportunities. This was passed as law in the

UK as of October 2013.

But does this alter shareholders' moral obligations to vote on pay? I say no it does not. Not if the only thing we are actually wanting shareholders to do is to vote on pay. Then these changes to control are not relevant to changes in moral obligations. Previous to such changes, private shareholders had the right but not the duty to vote if a corporate chose to provide them with such opportunities. I say that they had no duty, by which I mean no generally acknowledged, spoken of written duty. I thereby also support the view that a moral obligation does not apply to agents that are unaware of the fact that such demands are made on them. This differs from institutional shareholders that are morally bound to vote by the generally acknowledged principles of the UK Stewardship Code and the EFAMA Code for External Governance. As such institutional shareholder would have been under the moral obligation to vote on pay, provided that a corporate gave them the opportunity irrelevant of any changes. They would also have been under the moral obligation to make their votes public. What these amendments result in is therefore changes to the legal obligation to vote and does not alter the moral obligations to vote for either type of shareholder.

One reason that politicians provided the public with as to the reason to make such changes was to encourage further engagement between shareholders and corporates as they were seen not to sufficiently monitor the companies they invested in (2014 Press Release, European Commission). Again, if increased engagement and monitoring is simply defined by voting on pay, then again nothing has changed out of a moral perspective for either type of shareholder as per above. That is not to say that there will not be an increase in engagement or monitoring, for there clearly will be, simply as a result of the threat of legal punishment that comes with legal obligation.

However, there are other ways in which to measure engagement and sufficient monitoring beyond direct voting participation. Corporate boards are generally inclined not to want to be seen as proposing anything that goes against the interest of shareholders. Partly as a result of reputation, and the fact that it is the shareholders that vote for who sits on the board. But also, because they are seen as being under the moral obligation themselves to act in the interest of shareholders, which is supported by both the UK Corporate Governance Code (Financial Reporting Council 11:2014) that states that:

> The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

The OECD Principles for Corporate Governance (OECD 26:2004) further states that:

> Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

As such the proposed amendments of the European Shareholders Rights directive do give a control to shareholders beyond that of simply mandatory and binding voting rights. However, such additional control only truly relates to institutional and other major shareholders for it is these with whom management will want to increase their engagement with, in order to ensure that the proposals are accepted. This control relates to having more input into the process of deciding on what the actual proposal on pay will be. Yet the increase in such control comes with an increase in duties. This is a least true for institutional shareholders, who are morally obliged by the stewardship codes to act in the interest of their clients and beneficiaries. Institutional shareholders will now be seen as having a greater impact on the proposals themselves and as such have the obligation to ensure that these are in the interest of their clients and beneficiaries. For major private shareholders it may simply be the case that it is sufficient that the authorities have expressed their moral demand for increased engagement with corporates and that this change to legislation enables them to do it for such moral demands to apply to them.

6.1 THE GOLDEN RATIOS

Let us now turn to the two specific ratios proposed by the European Commission; the ratio between the fixed and variable parts of the remuneration and the ratio between the lowest and highest paid in the corporate. As no shareholder has previously been presumed to be in a position to vote on these matters there cannot be any change to previous moral obligations. This is at least the case when referring to the voting itself. However, what other kind of act may the authorities wish to promote by legislating mandatory and binding voting on these two ratios? As discussed in section four what politicians are further hoping to promote is a decrease to short-term risk taking (2014 Press Release, European Commission), and help tackling the widening gap between earnings of bankers and business executives and ordinary workers (2012 John O'Donnell).

Firstly, I would claim that smaller private shareholders would again not be able to have any control on these matters beyond casting their vote. As such they have no further obligations of any form. However, it is true that the reduction of short-term risk taking amongst managers can potentially be achieved by altering the fixed and variable parts of the remuneration ratio. It is again also true that by legally requiring a mandatory and binding vote on this ratio boards will be more inclined to engage with larger shareholders providing them with greater say. However, it is not clear whether institutional shareholders would always be looking after their clients' and beneficiaries' best interests, as demanded by the stewardship codes, if doing so. This is because not all clients or beneficiaries wish to invest for the long-term. Where this is not the case the demand on institutional shareholders to reduce short-term risk taking, and thereby possibly reduce higher short-term share performance, may directly conflict with the obligations they already have towards their clients and beneficiaries. Authorities could potentially counter this by demanding that any short-term rewards should not come at the cost of long-term interests. Institutional shareholders would then have to find other ways to satisfy the needs of short-term investors that did not involve increasing short-term risk taking within corporates. But this is not

something that has been sufficiently expressed by the authorities nor been consulted on. Therefor as things stand one moral obligation may directly conflict with another. It is not clear whether the moral obligation to reduce short-term risk within corporates should apply more dominantly to shareholders than their current moral obligation to their clients and beneficiaries. Institutional shareholders current moral obligations are towards clients, beneficiaries and society as a whole. Their current clients and beneficiaries have chosen to invest with them partly in light of these obligations and the duties that result from them. As such institutional investors cannot simply choose to violate their current obligations without their clients and beneficiaries acceptance. If they do not agree to such violations then they have a basis for complaint against the institutional shareholders. This is the type of argument that Gilbert (Gilbert 11.1999) uses when comparing a moral obligation to a promise. If the authorities, however, demand that institutional shareholders put another obligation above their current one, then they cannot be blamed, for such a decision would be out of their control.

The proposed voting on the ratio between the lowest and highest paid in the corporate could have an even more profound effect on institutional shareholders. For institutional shareholders to engage with management in order to reduce the earnings gap in a corporate it would have to be shown that this is to the benefit of their investors. However, there is very little to show that such an improvement in justice either generates higher equity returns or higher efficiency within corporates (M. Conyon & K. Murphy 2000). Furthermore, a 2013 paper published in the Journal of Banking and Finance, 'The Determinants and Effects of CEO-Employee Pay Ratios,' (O. Faleye; E. Reis & A. Venkateswaran 2013) looked at the relationship between relative pay and employee productivity. The study found no statistical significance in the relationship between the pay ratio and firm productivity. In fact they found that the firm value actually increases with increased relative pay for CEOs. A one standard deviation increase in the ratio meant a 5.3% increase in the firm value. Operating performance also increased with relative CEO pay.

What institutional investors are obliged to do is to ensure that management is not paid more than they deserve. A large multiple between the CEO and the average worker may throw up some questions and force the corporate to further justify the wage package. However, if the institutional shareholders then accept this justification, then it should not be their role to push through a change on the basis of other societal values of justice. If the European Commission wants to make institutional shareholders bound to drive such change, then this is a major transition in morality, and would force us to redefine what it is to be an institutional shareholder. If not, then such a moral obligation cannot apply to the current definition of shareholders.

7. CONCLUSION

This paper sets out to look at whether changes to the European Commission Shareholder Rights Directive on pay alter shareholders' moral responsibilities. Moral responsibilities are to be seen as shareholder's being under the moral obligation to act or refrain from acting in a given way. The proposed changes to

the directive include giving shareholders mandatory and binding voting rights on corporate pay, but also look at having them vote on two specific ratio's namely the ratio between the lowest and highest paid in the corporate, and the ratio between the fixed and variable parts of the remuneration. To determine whether these change shareholders' moral obligations this paper looks at the concept of moral obligations, what it is to be a shareholder and if the proposed moral obligations could indeed apply to shareholders. Given my acceptance that it is in virtue of societies demands that a morally required reason becomes morally obligatory, I explained that the European Commission is able to impose moral obligations on shareholders of all types that invest in European Corporates. What became clear is that there is a noticeable difference in smaller private shareholder responsibilities and institutional shareholders. These differences to responsibilities occur both because of the difference of level of control that the two types of shareholders have over corporate boards and because of the duties that institutional shareholders have in virtue of the UK Stewardship Code and the EFAMA Code for External Governance. The changes to responsibilities are concluded to range from simply being legal responsibilities to vote to having a profound impact on what it means to be an institutional shareholder. What significantly altered the responsibilities was the reading of how the European Commission ultimately wanted shareholders to act on the back of the individual changes. The most radical involving a major transition in morality, if the Commission do in fact want to make shareholders responsible for the reduction of pay-gap amongst workers and CEO's. Because the agreement between shareholders, corporates and others is so central to the definition of what it is to be a shareholder, any changes to shareholders rights or duties to any involved partners can have a strong impact on such a definition. However, if it is in fact the Commissions wish to go as far as demanding that shareholders play a greater social role, then they have not been sufficiently clear about it and as such it cannot apply as a moral obligation. Shareholders can simply not be said to be under a moral obligation of which they are unaware. Obligations are meant to make us act in a given way, if we do not know that we are expected to act as such, then we cannot be deemed to be morally bound to do so.

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