

GREEN PAPER on corporate governance in Europe and new orientations of the Commission- Towards a wider view of the CG?

Viviane de Beaufort

The Commission has adopted a Green Paper on corporate governance in Europe¹ and has launched, this summer, a public consultation on: “how to improve existing corporate governance mechanisms”. Having the crisis in mind, the ambition is to make a link between corporate governance and corporate social responsibility as key elements in building people’s trust in the single market and contributing to the competitiveness of European business. How to avoid box-ticking exercise and short termism approach?

At EU level a body of corporate governance principles already exist: several recommendations on the independence of non-executive directors, on board committees, and on remuneration and several directives: Directive 2004/25/EC on takeovers, Directive 2004/109/EC on transparency of listed companies, Directive 2007/36/EC on shareholders' rights, Directive 2003/6/EC on market abuse, 2006/43/EC audit Directive...

A large part of GC principles remain at a national level with national rules or codes, the European Commission has been decided in 2003 that a uniform corporate governance code should not be adopted ... The financial crisis proved that self regulation appears not sufficient. In this context a first Report on the Future of EU Company Law was published in April 2011 and in the same time a focus was made on CG issues in the Green Paper.

Among other issues, we give details on three essential topics:

- The better use of the “comply-or-explain” principle which is a feature of the EU approach to corporate governance;
- The enhancing of the engagement of shareholders;
- The promotion of a less short terms’ approach including diversity on boards to mix approaches and ethic of independence.

Michel Barnier said: *"In the current economic situation, we need more than ever to ensure that companies are well governed and consequently reliable and sustainable. Too much short term thinking has had disastrous consequences. That is why we have launched today a debate on the effectiveness of the existing corporate governance framework. Above all, we need company boards to be more effective and shareholders to fully assume their responsibilities."*

There is room for improvement mainly in three different areas of corporate governance:

1/ what about effectiveness of CG rules?

¹ COM(2011) 164 final

A very complete Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States² was published in 23 April 2009 and helps the Commission to identify possible “next steps”.

It appears there is a strong support for the comply-or-explain regime from regulators, companies and investors. Usually they said “we need sufficient flexibility to accommodate the specific situations of companies”. The comply-or-explain approach is therefore considered as an appropriate regulatory tool, but in the same time deficiencies in corporate governance practices have been highlighted as one of the causes of the financial crisis, therefore efficiency of the principle is in question.

National corporate governance codes lay down rules or recommendations with which companies must comply or explain deviations ; depending of the State some topics are regulated by law : each Member State has its own traditions and its own approach to corporate governance, as a result it is a patchwork of practices from a pan-European perspective. The way corporate governance codes are applied in each Member State is very diverse: some Member States did not take any kind of legal or regulatory action, in some Member States, listing rules do not specify that the code needs to be applied by way of comply-or-explain, as the codes itself mentions, in some others there is a mix of public and private regulation, and some Member States have chosen to impose the whole system by law or regulation... Corporate governance codes do not only differ in application, but also in content: depending on the size of the company, the ownership structures of companies and the nature of ownership...

Thus, how to be sure rules are able to promote informative quality of explanations rather than box-ticking exercise? It is a fact, that there is limited satisfaction with the quality of company disclosure. Companies mainly provide comply-or-explain information on board of directors and remuneration, shareholder rights and duties, disclosure, audit and other issues (risk management, internal audit function, corporate secretary, and irregularity declaration procedures for employees). These information still now are not really scrutinized because financial market authorities and/or stock exchanges monitor more the availability of information on corporate governance than the informative value of corporate governance statements.

To improve the whole system and have a chance to obtain valuable information, it could be possible to:

- Grant more monitoring powers to market wide monitors, it is the case in some EU Member States like Spain and Portugal: market-wide monitors perform an analysis of the informative value of corporate governance statement.
- The practice of auditing factual aspects of corporate governance statements which exist in few Member States could be extended at European level, in order to provide shareholders with the assurance that the information is accurate.
- Impose disclosure standards on how institutional investors address their fiduciary responsibility as owners of companies.
- Have a differentiated approach and provide specific provisions tailored to smaller companies. See, for exemple, in France « Code de gouvernement d’entreprise pour les valeurs moyennes et petites », December 2009, Middlednext³ or , in Belgium the Buisse Code — Corporate governance recommendations for non-listed enterprises .

² http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923_en.pdf.

³ <http://www.middlednext.com/> & http://www.codebuisse.be/downloads/CodeBuisse_EN.pdf

2/ What about Shareholder's engagement?

Shareholder participation ought to place corporate practices under closer scrutiny, but a lot of shareholders do not consider their role. Shareholders can be reluctant to use their rights and they stay passive, despite European efforts to maximize their rights⁴. A majority of investors devote few financial means and little time to these activities and only a small part has a real policy, exercise voting rights and have activities (correspondence, meetings with the board, physical attendance at general meetings). This situation is prevalent in Member States with concentrated ownership, and where no framework to encourage transparency from investors has been put in place.

How to encourage shareholders to use their rights? How to ensure that company general meetings be a forum for discussion on corporate governance practices? Is it possible "to put the discussion of the corporate governance policy or statement as an item on the general meeting agenda, introducing an advisory vote on corporate governance policy or statements, or even introducing a mandatory vote"? Do we need shareholder identification's mechanism to allow issuers to see who their shareholders are, and to give them means to improve shareholder cooperation? Should EU law require proxy advisors to be more transparent, e.g. about their analytical methods, conflicts of interest and their policy for managing them or/and should EU law restrains proxy votes?

Considering institutional investors, early in 2003, the Report of the High Level Group of Company Law Experts in its Recommendation III.7 specified: "regulation of the relevant types of institutional investors by Member States should include an obligation on institutional investors to disclose their investment policy and their policy with respect to the exercise of voting rights in companies in which they invest, and to disclose to their beneficial holders at their request how these rights have been used in a particular case." This idea is supported by the International Corporate Governance Network (ICGN), The European Fund and Asset Management Association (EFAMA) and National investors and asset managers associations but there is no European text today. A mandatory framework of voting reporting has been implemented in a number of Member States, either in law (France, the Netherlands, and Portugal) or in the corporate governance code (the United Kingdom), and the Walker Review to the Combined Code could inspired EU: The "Principles of Stewardship" of communication and engagement requires from institutional investors to explain on their website if they to follow these principles and if not to give explanation".

A difficult question remains: How to enhance interest in sustainable returns and longer term performance? Could we develop tools to encourage them to stay in the capital? EU regulation should seek to secure that companies have the option to include clauses allowing for differential voting rights or additional profit distribution rights in their Articles of association.

3/ Which ability to control compliance with CG codes and also risks?

The primary role of boards is to lead and control body of the company, to ensure compliance with corporate governance codes. Thus, boards have the responsibility to produce a corporate governance statement explaining the areas of compliance as well as the reasons for non-compliance. However, when there are controlling shareholders or dispersed ownership structure, boards may not be sufficiently independent or capable of protecting the interests of all shareholders. The active support of other participants should help:

⁴ Directive 2007/36/EC

- the involvement of auditors in the monitoring of compliance could be a good complement, but only if the corporate governance statement is included in the annual report and accounts and if it is the case, only if the auditor monitors the accuracy and informative value of the corporate governance statement which is not often the case;
- the involvement of shareholders makes also a difference, if and when they have a real policy and use legal tools to participate and monitor the way the board plays its role(see before). Some Member States encourage shareholders to take a more active role in monitoring the behavior of companies they have invested in. put some structures in place to inform the public on investors' activities;
- the role of market-wide public monitors.

The use of standard forms by companies could ensure that all the required information is disclosed. The example set by some Member States (Estonia, Hungary, Lithuania, Portugal, and Spain) demonstrates that the reliability and comprehensiveness of information may be improved if the information is provided in a structured and standardized form because it creates a level playing field for investors to compare information.

Information on the following issues should be included:

- _ Shareholder rights including information on general shareholders meeting;
- _ Ownership and capital structure;
- _ Board of directors, management and committees;
- _ Remuneration (can also form a separate report);
- _ Risk management and internal control;
- _ Compliance with the reference code on a provision-per-provision basis and explanations in cases of deviation from the code provisions.

The second role of the board is to deal with risk issues. Comparing national codes, it is clear that issues relating to the corporate governance mechanisms of boards are more complete than those relating to “risk management from the perspective of strategic scenarios and product development” or “transparency on financial and non-financial risk profile”. How to ensure that members of the board have sufficient information and are able to address risk questions?

The Directives 2006/43&46/EC⁵ require publishing a corporate governance statement including a description of internal control and risk management structures but the European Corporate Governance Forum has suggested in its Statement on Risk Management and Internal Control that “there is no need to introduce a legal obligation for boards to certify the effectiveness of internal controls at EU level”. The Transparency Directive 2004/109/EC (Art.4.2) requires the annual financial report to include a description of the principal risks and uncertainties that the companies face. In many Member States detailed risk management matters are largely left to national corporate governance codes on a comply-or-explain basis. National Codes specify that internal control should be carried out by some structured body within the company: internal audit function, department or unit and, in links with the statutory auditors⁶; but it is clear that to be effective and consistent any risk policy needs to be clearly decided by the board of directors for the whole organization.

⁵ Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC- Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings. http://ec.europa.eu/internal_market/company/ecgforum/studies_en.htm.

⁶ Directive 2006/43/EC introduced a wide set of brand requirements relating to the regulation of statutory auditors' activities.

Should the EU handle this question in a more precise way? The board should be responsible for the appropriate structures and procedures depending on the nature of the risks associated with its business which may range from financial risks (foreign exchange counterparty, etc.) to operational risks, including product safety, insider trading, leaks of business secrets or conflicts of interest⁷.

Efficiency of boards

Except qualifications and experience, how to ensure boards are also composed of a mixed group of people having different professional backgrounds and skills as well as nationalities and gender and that they allow sufficient time to their mission? Diversity in the members' profiles and backgrounds gives the board a range of values, views and sets of competencies⁸. It is about professional diversity, international diversity and gender diversity⁹. Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? Should listed companies be required to disclose their diversity policy? Should listed companies be required to ensure a better gender balance on boards? Availability is also a key condition, therefore should we limit the number of board mandates a director may hold at the European level to ensure non-executive directors devote sufficient time to monitoring and supervising their particular companies. At least, board evaluation should intervene regularly: the previous Commission's Recommendation on the role of non-executive or supervisory directors of listed companies (2005) already stated that the board should evaluate its performance annually. Should we go further and give details on the process?

The work of the European Commission shows that the whole approach and analysis is more complete and differs from before adopting a global perspective, but we could not make sure the final result will not fall in the classic (liberal) approach of CG. A "crash test" could be the way the EC will address the key issue of the short-termism view of the market¹⁰.

The European Commission, for the first time in its approach, asked sound questions on the limits of the system and seems ready to modify rules to avoid short-termism. Over the last decades the focus of listed companies has moved to long term orientation to a short term perspective due to "the role of institutional investors, pressure of markets and investors to achieve greater and faster returns with the distribution of cash and the rise of shareholder activism by hedge funds and private equity, in combination with the vast liquidity that was available in the market". The way asset managers' performance is evaluated and the incentive structure of fees and commissions encourage asset managers to seek short-term benefits. Some accounting rules and some financial regulations or practices also could lead to measuring performance on a short term basis.

How to avoid short-termism of capital markets? Should current EU legislation be reviewed against the background of whether the rules promote or at least facilitate a long term perspective? An example is

⁷ See Reflection Group on the future of EU company law p. 43&44.

⁸ 'Enhancing stakeholder diversity in the Board room', 'The Erfurt meetings' series, No1, March 2008, European Citizens' Seminars e.V. (Erfurt, Germany) publishers.

⁹ "Strategy for equality between women and men 2010-2015" of September 2010²³ & Commission Staff Working Paper "The Gender Balance in Business Leadership", SEC(2011) 246 final.

¹⁰ See Reflection Group on the future of EU company law p. 36&37

quarterly reporting, which could be considered to be made subject to an opt-out by listed companies.
Could we create EU rules or measures to better align the interests of long-term institutional investors?
Encourage indicating long term objectives in the company's corporate governance report?
Moreover having in mind not only the shareholder's interest, but the interest of the company as a whole.
moving back to basics CG rules !

Viviane de BEAUFORT

**Professor at ESSEC BUSINESS SCHOOL, “Jean Monnet chair” (European Commission 2006)-
Doctorate in European Community Law, University of Paris I - La Sorbonne ,and Master's Degree
in Political Science, University of Paris X . Director of the “law chair ” ESSEC and co-director of
the European Center Law and Economics. Author of several books and articles on corporate law
and European Corporate Governance and European institutional issues. Involved in several think-
tanks on European topics. She works on European public affairs especially on lobbying,
competitiveness, competition and CG issues.**