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Response to the European Commission's Green Paper "The EU Corporate Governance Framework"

European Company Law Experts

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22 July 2011

Introductory statement

We first set out briefly the rationale for having rules on corporate governance, whether those rules are determined at national or EU level and whether they are contained in hard or soft law. We then consider the rationale for taking action at EU level. Thirdly, we make a suggestion as to how the choice between hard and soft law should be made. Fourth, we consider the overall implications of the previous arguments for the division of rule-making between the EU and Member States.

We suggest that the rationale for corporate governance rules is to address agency problems. Within corporate law, agency problems fall into three categories: those between the management (agent) and the shareholders as a class (principal) where shareholdings in a company are dispersed; those between controlling (agent) and non-controlling (principal) shareholders where shareholdings are concentrated; and those between the controllers of the company (agent) and non-shareholder stakeholders (which agency problems exist whether shareholders are concentrated or dispersed). Following the Green Paper's format, we concentrate predominantly on the first two agency relationships. An issue to be noted at once is that a particular legal mechanism may operate to mitigate an agency problem of one type, whilst reinforcing an agency problem of another type. Thus, a power for shareholders easily to remove members of the board may mitigate the agency problems of the shareholders as a class whilst reinforcing the agency costs of non-controlling shareholders.

Corporate governance issues have traditionally been addressed at Member State level, with limited rule-making at Community level based on the harmonisation clause related to the freedom of establishment, article 50 par. 2 (g) TFEU . This is in line with the principle of subsidiarity laid down in Article 5 TEU. Thus, there is a need to identify a rationale for rule-making at EU level in relation to corporate governance, if rules are to be made at this level. The obvious role for EU rules is where there is a need to address cross-border issues which national legal systems are, by definition, less well able to address. We suggest that this means that the EU corporate governance rules be confined to companies whose shares are publicly-traded. Although it is conceivable that the shareholders of a publicly-traded company are all located in a single Member State, the

evidence is that, at least in major publicly-traded companies, a substantial proportion of those shareholders, especially in the case of institutional shareholders, come from outside the jurisdiction in which the company is incorporated.

Figures from the Federation of European Stock Exchanges show that, at the end of 2007, foreign investors owned 37% of the value of listed shares on European exchanges. This has been slowly increasing in recent years. There is some variation across countries, both in the current position and rate of change. For example, domestic investors hold 70% or more of the market in Germany and Italy, whilst they hold less than 30% in the Netherlands. Between 1999 and 2007, foreign ownership increased notably in Belgium, Germany and the UK, but fell in Italy.

It also follows from this argument that there is a stronger rationale for EU intervention in relation to shareholder rights than in relation to board rules. This rationale, we suggest, already underlies the Shareholders' Rights Directive which the Community has adopted. We think that this is the right general principle and that therefore the Commission should not seek to bring non-publicly traded companies within any proposals it may make. We discuss below in our answer to Q 1 the definition of a 'publicly-traded' company.

However, it is not enough to justify EU rule-making that the population of companies should have a cross-border shareholder body. It must also be the case that the objectives of good corporate governance will be promoted by having a common rule across all the Member States. In some cases we think this is the case, as the Shareholder Rights Directive demonstrates, but in the case of rules relating to the functioning of the board, we think that typically this is not so, unless a specific case for this is made. We return to this issue below.

We now turn to our third preliminary point. Irrespective of whether the rules are made at EU or Member State level, should they take the form of 'hard' law or 'soft' law? By 'soft' law we usually mean rules which are put on a 'comply or explain' basis. Such rules have two features. First, they are underpinned by a hard law obligation on the relevant population of companies to disclose the extent of their compliance with the rules and to explain areas of non-compliance. Second, the burden of taking action, if any, in relation to areas of non-compliance rests with the company's shareholders, who may respond by accepting the explanation or, alternatively, sell their shares (thus potentially driving down the market price of the shares) or seek to produce a change in corporate behaviour through the exercise of their governance rights.

All Member States have some corporate governance rules in hard law provisions (Companies Acts, Commercial Codes) and some in corporate governance codes put on a 'comply or explain' basis. In all jurisdictions, however, the most intrusive and detailed corporate governance rules are in the codes. We suggest that there is a very good reason

for this approach. There does not exist a single corporate governance format which constitutes the best arrangement for all companies. This is true even if the statement is confined to companies listed on a regulated market. Corporate governance is about process and method, rather than particular outcomes. Good corporate governance in terms of balanced decision-taking and proper checks and balances, can be achieved through different processes. Consequently, it is efficient to allow companies to deviate from the best practice model laid down in the code provided the company has a good reason for the deviation - and the aptness of the reason for deviation is best judged by the shareholders of the company rather than a court or a regulator. Thus, Arcot and Bruno in a study of the UK Corporate Governance Code found that companies which provided full explanations for non-compliance with the provisions of the UK Code outperformed not only companies which provided inadequate explanations but also companies which complied fully with the code. Thus, rules not put on a 'comply or explain' basis run the risk of generating inefficient outcomes. One reason why comply or explain may be a more efficient form of rule-making than hard law is that we do not understand fully the relationship between board rules and board behaviour, so that the assumptions under which a corporate governance rule is made may turn out to be falsified in practice. This view supports giving (constrained) flexibility to companies in their responses to corporate governance rules.

Of course, all Member States put some corporate governance rules in hard law. Some rules may appropriately be located there, for example, rules relating to shareholder voting rights, the convening of general meetings or shareholder rights to appoint or remove directors. However, rules which concern the core functioning of the board are, for the reasons given above, better contained in soft law.

The fourth and final preliminary question we address is whether the 'comply or explain' rules should be made at EU or Member State level, even in relation to publicly-traded companies. This issue was considered by the High Level Group in its final report of 2002. It rejected the idea of the development of a European Code of Corporate Governance. This was for two main reasons. First, the EU rules were unlikely to add anything useful to the national codes, as Europe would either have to allow many alternative rules, depending on the various company law systems, or to confine itself to abstract, and perhaps meaningless, rules which would be compatible with all of these systems. The second reason was that corporate governance codes should be made closer to the market than EU rule-making would permit. The key input for codes of corporate governance should come from the market and market participants. These codes are a means of building up reputation by voluntary compliance with rules of good behaviour. The market and its participants know best what rules enhance reputation. The EU as well as Member States should leave it to those who have an own interest in such codes, i.e. companies, investors, stock exchanges, etc. to take the initiative, while continuing to monitor the situation closely.

The High Level Group thus recommended, and the Commission later accepted, that the Commission should not seek to develop a European Corporate Governance Code. However, this conclusion did not leave the Commission without a role in relation to corporate governance codes. It should take up an important coordinating role in relation to the national codes, seeking to spread best practice, where it existed and could be identified, to the Community as a whole. The instrument of Commission Recommendation is particularly suited for taking such a coordinating role, leaving scope for Member States to bring about the stated objectives in ways that allowing dealing with the national company law and other factors relevant in each Member State.

The financial crisis has revealed serious flaws in the governance of certain financial institutions. Although we would not argue that failing corporate governance was a root cause of the financial crisis, the failures and their impact are serious enough for them to be addressed specifically. In particular the position of creditors, among which depositors, and tax-payers following government bail-outs, warrants specific attention to elements of the corporate governance of financial institutions. The recent Commission's proposals for a CRD IV Directive and Regulation address certain governance elements for credit institutions and investment firms, with a strong role of national regulators to permit deviations from mandated governance arrangements.

We do not believe that such an approach is warranted for listed companies in general, with which this Green Paper is concerned. The position of creditors and the exposure of tax payers are decisively less significant in non-financial firms. We also believe that the financial crisis has not thrown up any evidence that corporate governance in non-financial firms operated badly during this period. Indeed, it can be argued that it performed as expected and well.

We therefore conclude that the Commission should not today seek to develop a European Corporate Governance Code but should continue to coordinate the activities of the Member States in this area, notably through the generation of Commission Recommendations.

However, this conclusion leaves one important issue unexplored. The Commission remarks at the end of Section 3 of in the Green Paper, in which it discusses the 'comply or explain' approach, that "these solutions are without prejudice to the possible need to reinforce certain requirements at EU level by including them in legislation rather than making recommendations." As we remarked above, all Member States have some corporate governance rules in their laws as well as in corporate governance codes. However, we suggest that the policy of dealing with the most intrusive matters (especially board rules) in codes does in fact have implications for the use of hard law to regulate such issues. As the High Level Group said in its final report:

“we would like to stress that corporate governance is a system. It has its foundations partly in company law, setting out the internal relationships between the various participants in a company, and partly in the wider laws and practices and market structures which operate in different Member States. It follows that there are dangers in dealing with particular components of the corporate governance system in isolation from their wider context.”

There are risks in taking particular topics out of codes and transferring them to legislation. This is so when the legislation is enacted at Member State level and even more so when the legislation is enacted at EU level, since EU legislation is more remote from national systems of corporate governance. This is not to say that moving a particular topic to legislation is never an appropriate policy but rather that a strong case indeed must exist before this step is taken. We discuss below some situations in which we think this step may be appropriate or inappropriate.

I. General

Question 1

Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and medium-sized listed companies be established? If so, are there any appropriate definitions or thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.

As we have indicated above, we think that, if EU rule-making is justified in relation to a particular topic, the rules should be confined to publicly-traded companies. We think that in principle there is justification for including all publicly-traded companies (not just those with securities traded on a regulated market) within EU rule-making. Many jurisdictions have second tier public markets, which may not be regulated markets, and some have third-tier markets (such as Plus-markets in the UK) which are unlikely to be regulated markets. Both these second and third tier markets may have a cross-border shareholder body, though probably to a lesser extent than companies traded on a regulated market.

However, it is clear that, once one moves away from regulated markets, there may be a significant shift in the balance of costs and benefits resulting from regulation. In many jurisdictions the full corporate governance code applies only to companies with securities traded on a regulated market, though there may be some lesser set of standards, often of a less formal nature, applied to companies on secondary or tertiary markets. Our recommendation above was that the Commission should not seek to develop a European Code of Corporate Governance and should instead play a coordinating role

through Commission Recommendations. If this path is followed, it will be relatively easy to make distinctions in the Recommendations among companies on different markets, precisely because the Recommendations do not generate hard law. From a point of view of balancing protection of investors and issuers access to capital markets a gradually ascending set of corporate governance requirements across tertiary, secondary and regulated markets may be preferable to a jump from nothing to a full corporate governance code when a regulated market is reached.

If hard law proposals result from the Commission consultation, we think it may be very difficult (a) to make distinctions among publicly-traded companies according to size, and (b) to produce a single legislative rule which is appropriate for all publicly-traded companies. Accordingly, in practice it may be difficult to do other than confine the hard-law proposals to companies on regulated markets. However, we do not in principle object to extending a particular hard-law proposal beyond regulated markets, provided a cost/benefit analysis supports such an extension and an appropriate cut-off point can be identified for the proposal.

We have talked above about companies with securities which are publicly-traded. It seems to us that a much less demanding set of rules is required when the only securities which are traded are bonds. It may be that corporate governance requirements for bonds-only companies can be left to the contracting process which leads to the bond issuance.

Question 2

Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting development and application of voluntary codes for non-listed companies?

As has been indicated above, we do not think the EU should proceed with the making of rules (even soft law rules) for the corporate governance of companies which are not publicly-traded.

II. Boards of directors

Question 3

Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?

We believe that there should indeed be a clear distinction between the functions of the chairman of the board and of the chief executive officer. Companies could be encouraged to provide clear descriptions of these respective roles, which would help them to shape their governance structure and which would also enable investors to hold

the board accountable in this respect.

We do not believe, however, that the EU should seek to prohibit outright that the chairman and the CEO functions are performed by the same person as is proposed for credit institutions and investment firms in the CRD IV Directive. There is a trade-off here between monitoring and efficiency of decision-making. A CEO has high quality information which he may use, in his capacity as Chairman, to facilitate efficient decision-making. At the same time, it will be more difficult for non-executives to monitor the executives given the dominant position of the Chairman-CEO. The balance between the need for efficient decision-making and the need for monitoring will be different for each company depending on variables such as firm size, industry, ownership structure, market circumstances etc. Therefore, individual listed companies should be allowed to choose the structure that fits them best.

The EU could usefully promote these underlying objectives, efficiency of decision-making and monitoring. Both functions require that there are sufficient countervailing powers in the board. If the functions of CEO and Chairman are combined, such countervailing power should be ensured by the appointment of a senior independent director (SID). This also seems appropriate in companies where the Chairman has previously served as CEO (and no waiting period has been applied). A SID can take the lead among non-executives in terms of monitoring of the executives, and can also serve as a point of reference for shareholders, who, too, function as monitors.

Question 4

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? If so, how could that be best achieved and at what level of governance, i.e. at national, EU or international level?

It is obviously important for directors to have the right skills, and we also believe that there is value in diversity especially among non-executive directors and supervisory directors. Diversity may result in complementary perspectives being considered in the decision-taking process and may help to oppress cognitive biases that are easily enhanced in group decision-taking processes. Recruitment policies should seek to ensure that the composition of the board is sufficiently diverse along various dimensions, such as background, experience, expertise, age, nationality and gender. The EU may play a useful role in encouraging listed companies to carefully consider their recruitment policies, and possibly to require them to publish such policies (see also answer to question 5 below). However, we do not believe that the EU should go beyond this and prescribe the actual contents of recruitment policies. At most, the EU could list certain items, such as skills and diversity, which should be addressed in recruitment policies. We also note that notions such as diversity, like the notion of independence, do not bring absolute qualities to a board in the sense that more is always better. An excessive insistence on

independence comes at the cost of expertise on the board. The same is true for diversity.

Question 5

Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?

Requiring companies to disclose whether they have a diversity policy as such might be useful, as might be a brief description of its objectives and main content. This could be required as part of the broader requirement that companies publish their recruitment policies, provided that the EU should not attempt to prescribe how diversity is to be achieved (see also answer to question 6 below).

Question 6

Should listed companies be required to ensure a better gender balance on boards? If so, how?

As becomes clear from the answers to question 4 above, we believe that there is added value in diversity among non-executive directors and supervisory board members given that diversity may result in complementary perspectives being considered in the decision-taking process. However, we are not convinced that the EU should take steps to mandate gender balance. Diversity can be achieved along different dimensions, and gender diversity is but one dimension. There is some evidence that a sufficient representation of both genders contributes to the quality of decision-taking in boards, but the evidence is not so clear and overwhelming as to suggest that, from a corporate governance perspective, a sufficient level of gender diversity should be mandated. Various Member States have taken initiatives to require or encourage a sufficient level of gender diversity on boards of companies. These initiatives are all primarily based on considerations of social and emancipation policy. For the time being there does not seem to be EU wide consensus on the level of gender diversity that is to be achieved and on the way to do so. What is appropriate is best decided at Member State level. The EU could play a meaningful role in encouraging listed companies to strive for an appropriate degree of diversity, and leave it to the companies themselves to determine how to achieve this within the national framework under which they operate.

Question 7

Do you believe there should be a measure at EU level limiting the number of mandates a non-executive director may hold? If so, how should it be formulated?

Given the importance of adequate monitoring of executives and the complexity of the business and organisation of many listed companies, we believe that non-executives can be expected to devote sufficient time to their role. An increase in time commitment should naturally lead to a reduced availability for board positions. We are not convinced

this particular issue should be a priority for the EU at this moment. The corporate governance developments over the last decade have resulted into an increased expectation of the commitment of non-executives and this has generally lead to a voluntary reduction of number of mandates, sometimes prompted by explicit corporate governance code provisions to that extent. It would be interesting to conduct an empirical study into the number of mandates non-executives of listed companies in the EU currently hold on average and how this has evolved over the last decade. It may be that the problem of too many mandates is solving itself in practice or by Member State regulation without any need for EU intervention. In any case, there should be proper exemptions for non-executive directorships in subsidiaries, in which case this directorship is inextricably linked to the directorship at holding level, as acknowledged in article 87 of the proposed CRD IV Directive.

Question 8

Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?

Board reviews are valuable, if they go beyond a formal exercise and touch upon substantive issues like strategy, role of non-executives, conflicts within a board and the contribution of individual members. Often board reviews clarify issues that directors would find otherwise difficult to discuss and would in any case fall beyond regulatory reach. An external facilitator may help solving issues that the board alone would find difficult even to detect. We are in favour of recommending board evaluation on a regular basis, subject to comply or explain. Boards should be encouraged to conduct a self-assessment annually, with the assistance of an external facilitator every three years. In two-tier systems, the supervisory board should evaluate both its own composition, organisation and functioning as well as the composition, organisation and functioning of the management board. However, best practices should be developed to prevent board reviews being conducted as a box-ticking exercise.

Question 9

Should disclosure of remuneration policy, the annual remuneration report (a report on how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?

This is already the rule in the UK and the Netherlands and in Germany with a more limited content, but not in the rest of Europe where presentation and format requirements differ. The majority of Member States do not require companies to produce a separate remuneration report. Most national rules or codes provide that remuneration disclosure can be offered anywhere in the annual report, including in the corporate governance report, in the management report and/or in the notes to the financial statements. Greater transparency should be supported by a requirement for standardised tabular reporting. Only a few Member States require that

remuneration policy disclosure be provided, although corporate governance codes tend to recommend this type of disclosure, albeit without specifying the detailed elements identified in the 2004 Recommendation.

No doubt, individualised disclosure of directors' pay, which identifies the fixed and variable elements, is central to effective remuneration disclosure. Significant improvements have occurred in this regard in the last five years or so, although shareholder assessment of this disclosure is hampered by the poor implementation of the parallel disclosures on the underlying policy. Where individualised disclosure is required or recommended, variations in the particular disclosure required are common, with the UK regime still requiring the most detailed disclosures. Individualised disclosure of the remuneration received by directors during preceding years, for example, is recommended in only a few national codes.

Disclosure requirements for share-based incentive schemes (as stipulated by the 2004 Recommendation) are typically required by law, but also in corporate governance codes. Nonetheless, disclosure concerning vesting periods, lock-up periods and valuation methods applied (in order to determine whether performance criteria have been fulfilled) is required only in some Member States. The UK disclosure requirements for share incentive schemes and performance conditions are particularly stringent.

We believe that strong remuneration governance, including disclosure, can promote executive pay contracts which achieve efficient incentive alignment and that a pan-EU approach brings efficiencies. In the absence of binding rules, firms appear reluctant to provide full disclosure concerning remuneration, particularly on the pay/performance link and on termination payments. It is not possible to compare with any degree of ease how Europe's listed companies address executive pay and, in particular, their approach to performance conditions. The risks of board-level conflicts of interest and of minority shareholder oppression, the growth in incentive pay, the persistence of poor disclosure practices and the apparent reluctance of Member States to intervene in this area suggest that a binding regime may carry benefits.

Given that disclosure can promote stronger shareholder monitoring and act as a deterrent to rent-seeking at board level, it seems therefore that there is a market failure which legislative intervention by the EU could address. Although disclosure is perhaps more strongly associated with supporting shareholder monitoring in dispersed ownership companies, it remains an important tool in companies with concentrated ownership, for at least two reasons. First, disclosure helps to reduce the agency costs of controlling shareholders, particularly when they are also the managers of the companies concerned. Second, when outside professional managers are employed, controlling shareholders can effectively monitor their pay for the benefit of shareholders in general; disclosure will also provide evidence of this monitoring for the benefit of other companies. Positive externalities with respect to pay governance may therefore follow.

We suggest that a binding requirement for a separate remuneration report, providing a clear, “one-stop” evaluation of the different elements of remuneration and explaining the underpinning remuneration policy, be introduced. Standardisation of the format in which disclosure is provided would also support better monitoring and positive externalities, given that comparability across companies is currently very difficult to achieve.

We also point to a concern triggered by the requirement of disclosure of individual director pay. In some Member States we see a movement to avoid disclosure by reducing the number of executive directors and appointing managers in de facto executive roles without formal directorships, sometimes as members of so called executive committees. Non-director executives sometimes receive substantially higher remuneration than executive directors. From a governance perspective this is a matter of concern but we believe Member States should first of all address this, as the questions at hand are linked to particular board and executive management structures that may deviate from Member State to Member State.

Question 10

Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?

In most Member States a vote on the remuneration report generally or on company remuneration policy is not a separate item on the general meeting agenda. This reluctance to engage with a direct “say on pay” may reflect the influence of controlling shareholders in the respective jurisdiction or in particular firms, as well the more limited role of the general meeting in concentrated ownership governance. The UK and the Netherlands are exceptions. The UK 2006 Companies Act (reflecting earlier reforms in 2002) requires listed companies to prepare a Directors’ Remuneration Report and to put the report to a shareholder vote. The vote on the ex post report is advisory and requires a 50% majority of those voting. The Netherlands since 2004 requires that the remuneration policy be adopted ex ante by the general meeting, with the ability to deviate from a proposal of the supervisory board. The policy is about the categories, maximum amounts and criteria for future remuneration, not about the individual pay of each director within that policy, which is typically determined by the supervisory board. The general meeting decides on the policy with a normal majority.

Recently, other Member States have introduced a vote on company remuneration policy. In Sweden, the remuneration policy must, by law, be submitted for approval to the general meeting ex ante. The Spanish Corporate Governance Code similarly requires that boards should submit a consultative report on the directors’ remuneration policy to the vote of the general meeting of shareholders as a separate item on the agenda. The 2009 German Act also introduces the ability for the general meeting to take an advisory shareholder vote on remuneration policy, which has been strongly supported by

shareholder groups. The vote is without prejudice, however, to the rights, competences and liabilities of the supervisory board.

The position concerning the approval of share-based incentive schemes is different. Most Member States have either recommended or, more usually, imposed by law a requirement for shareholder approval of share-based incentive schemes, although divergences also exist here.

We submit that the benefits of “say on pay” are still controversial also in countries that already require a vote on either remuneration policies or remuneration reports. Evidence suggests that shareholder approval has some impact on the structure of remuneration (more performance related), but not on its level (which continues to increase as a multiple of ‘ordinary’ workers’ salaries). On the whole, we would refrain from making “say on pay” mandatory at European level and in any case would limit any intervention to the requirement for either an advisory vote on the remuneration report or a binding vote on remuneration policy.

Question 11

Do you agree that the board should approve and take responsibility for the company’s ‘risk appetite’ and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?

Taking responsibility for the company’s risk appetite and reporting it to shareholders is already best practice for boards in Europe, when not required by national laws with respect to either all listed companies or those operating in specific sectors. Financial institutions, in particular, are subject to mandatory requirements concerning the board’s oversight role and responsibilities as to risk management. For other firms, we would in principle avoid detailed regulation, with the exception of those operating in some (generally regulated) industries which may pose large or even systemic risks. Also reporting on risk management systems and oversight is generally required at national level. However, we would not recommend further detailed EU regulation of reporting which would be difficult to implement and not always useful.

Question 12

Do you agree that the board should ensure that the company’s risk management arrangements are effective and commensurate with the company’s risk profile?

We agree with this obvious statement, but would not suggest EU regulatory action in this area. Directors’ fiduciary duties, including the duty to monitor risk management arrangements, are subject to national company law as implemented by the courts through liability cases. We do not see the need to harmonise national provisions concerning fiduciary duties, which are closely linked to other aspects of each Member State’s regulatory framework, including board models, securities regulation, civil procedure and

tort law. Each Member State is, therefore, optimally placed to legislate on fiduciary duties, taking all specificities of domestic corporate governance into account and also considering the role and quality of private enforcement in this area.

In any case, we believe that the board responsibility for risk management supervision should not imply that directors are always liable for risk management failures. On the one hand, these failures are difficult to identify. The mere fact that a risk materialises does not mean that a risk management failure has occurred; and even if a risk management failure is found, it still needs to be proven that proper oversight by the board could have avoided it. On the other hand, the organisation, operation and supervision of risk management systems belong to the “business judgement” sphere. Therefore, directors shall often be excused from liability under the business judgement rule, which is commonly found in national jurisdictions. Despite different formulations in Member States, the rule generally requires the court not to second-guess the directors’ judgement, provided that the latter performed their duties in good faith and exercised due care. In the case of a risk management failure, board members would generally not be held liable unless it is proven that they had not assured themselves that a proper risk management system was in place and operating before the risk materialised. We see no reason for any changes to this basic element of director liability.

III. Shareholders

Introduction

The shareholder-related questions in the Green Paper raise a fundamental question. This is whether closer shareholder engagement with the company is to be encouraged or discouraged. The traditional argument for placing ultimate control over companies in the hands of the shareholders and encouraging them to use those control powers in appropriate circumstances is that the shareholders are the residual claimants on the company’s revenue stream and thus have the strongest incentive to reduce the company’s costs of production, for the benefit of society as a whole. Recent criticism has focussed on the alleged short-termism of (especially) institutional shareholders. This short-termism, it is said, may take the form of not engaging with portfolio companies or, alternatively, engaging with them but in pursuit of short-term goals. Thus, pension funds are often criticised for not being sufficiently interventionist, whilst hedge funds are criticised for the opposite reason: too much intervention. There is anecdotal evidence to support both these propositions – and a number of other ones.

However, our main point is that we do not have a very sophisticated understanding of the relationship between investment strategies and intervention in portfolio companies or the links between such intervention and the long-term success of portfolio companies. Some intervention by investors with short-term goals is good because it brings about change which long-term investors want but cannot themselves cheaply bring about.

Sometimes long-term support for a company means keeping inefficient incumbent management in place. But equally, the opposites of these propositions also hold true in some cases.

We think that more work needs to be done in this area before legislation or even codes of conduct are adopted. Otherwise, the risk is that legislation will misfire, not curing the problem aimed at or even making it worse. It is crucial to understand whether this criticism is well founded and, if so, what the drivers of short-termism are. If the drivers are essentially regulatory, regulation should be reformed. If by contrast the short-termism results from the investment strategies of the institutions themselves, this casts doubt on the policy of giving shareholders ultimate control – or at least suggests that certain types of shareholders should be excluded from control rights. If the criticism is not well founded, then reducing shareholders' control rights runs the risk of simply entrenching incumbent management. We suggest that the issues of short-termism need careful study before legislative action is taken. It is suggested that at present the answers to the questions noted above are not well understood and so any immediate legislation proposals should err on the side of caution. This proposition underlies our responses to the specific questions which follow.

We also note that the issue of the legitimacy of the control rights of shareholders raise questions not addressed in the Green Paper, perhaps because they will be consulted on elsewhere. In particular, the tradition argument of ultimate shareholder control of companies assumes that a shareholder has both an economic and an equivalent voting interest in the company. Consequently, 'empty' voting, where the voting right is divorced from the economic interest, whether through share borrowing or hedging, pose a challenge to the traditional theory. It may be that this issue cannot be solved without re-visiting the whole debate about 'one share, one vote'.

Question 13

Please point to any existing EU legal rules which, in your view, may contribute to inappropriate short-termism among investors and suggest how these rules could be changed to prevent such behaviour.

There are a significant number of EU and national rules which may militate against engagement by long-term shareholders with their portfolio companies – though, as we have stressed, our understanding of how these factors interact is not good. These rules have all been adopted in pursuit of good policy objectives, but we suspect without their impact on engagement by investors being taken into account. There may be a case for some re-balancing.

- Rules addressing the concentration risk of pension funds and insurance companies (and which thus put limits on the proportion of the shares in a company any one institution can hold or the proportion of the fund which can be invested in any one company) are aimed at de-risking these investments for the benefit of their ultimate beneficiaries. However, by encouraging diversification by long-term institutions, these rules increase the costs of intervention in portfolio companies (there are more of them and the gains to the institution from any single episode of intervention are less) and thus reduce the propensity of institutional shareholders to intervene.
- Prudence and due care requirements provide an incentive to institutions to engage in herd behaviour, i.e. to follow the market rather than to challenge it by supporting management which is currently out of favour with the market. These requirements cause fund managers to think that it is better to be conventionally wrong (i.e. do no worse than the market) than unconventionally right (i.e. be shown to be right but only after a sustained period of below-market performance). During the period of sub-market performance the managers will face criticism and possibly even liability suits.
- Even when institutions wish to intervene, regulation may put barriers in the way, and so raise the costs, of inter-institution co-operation which is a necessary ingredient for successful engagement, if management is resistant. These rules are discussed below in the answer to Question 17.
- Proposed capital rules for insurance companies discourage them from holding shares and encourage the holding of bonds. Thus, the potential for insurance companies to act as long-term investors is reduced.
- Other regulatory requirements may operate to reinforce short-termism, though they can hardly be said to require it. Thus, quarterly and significant event reporting and mark-to-market accounting all emphasise the importance of having a constant, accurate assessment by the market of the current value of the company's securities. However, these regulatory requirements do not require investors to react in any particular way to the information released. To some extent, the existence of these requirements reflects investor demands and thus is an expression rather than a cause of short-termism.

Question 14

Are there measures to be taken, and if so, which ones, as regards the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

We assume this question relates to external asset managers who are mandated by institutional investors to manage parts of their portfolios. We believe that external asset managers are remunerated primarily on a ‘funds under management’ basis, which means that they have a strong incentive not to lose a mandate. If our answer to question 13 is correct, this means that asset managers will also have a strong incentive not to fall below the market to avoid losing mandates, and therefore to adopt a short-term approach. Thus, as far as remuneration structure of asset managers is concerned, the problem lies more with the incentives of the institutional investors who give the mandates than of their asset managers.

Any suggestion that the remuneration of asset managers should be re-structured by regulation in order to encourage long-term engagement should be treated with extreme caution, for it is unlikely to be clear how those incentives would work out in practice.

However, see further our answer to question 16.

Question 15

Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how?

In principle, we think that the appropriate extent of monitoring of asset managers is something for institutional investors themselves to decide. The institutional investors have every incentive to ensure their managers do what they want. If the institutions are subject to inappropriate incentives, (see question 13), those should be addressed directly.

This question and the following one specifically refer to the role of EU law. Given the variations in the way institutional shareholder structures are established in the Member States, we think any such intervention, even if it is necessary, which we doubt, should be at national level, but subject to co-ordination at Community level.

Question 16

Should EU rules require a certain independence of the asset managers’ governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

As a qualification to our answer to Question 14 asset managers may indeed face conflicts of interests that warrant regulatory intervention. There may be a distinct problem where the asset manager is part of an investment bank which also provides other services, notably corporate finance advice and underwriting services, to the companies in which the fund is invested (‘portfolio’ companies). There is strong anecdotal evidence that this arrangement gives rise to a conflict of interest which makes asset managers reluctant to engage with portfolio management to whom it hopes to sell corporate finance services.

Where the investment bank has underwritten a securities issue the asset manager may be compelled to include these securities in one or more of the funds under management which may not be in the interest of the investors in these funds. Also, when asset managers manage a series of investment funds this may lead to conflicts of interests in the allocation of costs, benefits and marketing efforts to the funds. However, designing a solution to this problem is difficult, since to insist that fund managers be free-standing may reduce the choice and expertise available to funds, whilst solutions short of polarisation may be ineffective. An intermediate solution may be the one suggested in the question, ie requiring the asset management arm of a financial conglomerate to be set up as a separate subsidiary with a majority of independent directors. Such a solution has been suggested in some Member States and has typically met with resistance as this would put asset managers in those Member States at a competitive disadvantage to asset managers in other Member States. Where Member States individually find it hard to address the problem, this clearly calls for an intervention at EU level.

Question 17

What would be the best way for the EU to facilitate shareholder cooperation?

We think there is a useful role here for EU law, not just EU coordination. There are two aspects to it. First, regulatory obstacles to cooperation among shareholders should be removed. The obvious obstacles are the definition of acting in concert (which may trigger both disclosure and mandatory bid requirements) and the scope of the market abuse directive, in particular on price-sensitive information (which may discourage shareholders from engaging with management for fear of losing liquidity). Shareholders would be better able to cooperate across borders if these definitions were the same in all Member States. This argues for moving to a maximum harmonisation definition of these terms. However, maximum harmonisation will only benefit shareholder coordination if it is on the basis of a definition which reduces the regulatory obstacles to shareholder engagement. This may involve some qualification of the policy objectives which the original regulation was designed to promote (minority protection in the case of the mandatory bid; equal access to information in the case of the market abuse directive). This may not be easy to achieve.¹

Second, there is a role for EU law to facilitate shareholder communication across borders. It should be possible with modern technology for the company to provide via its web-site a process whereby shareholders can identify other shareholders in the company, communicate with them and seek their support on issues which are put to a shareholders vote. See also our answer to Question 20.

¹ For an attempt to square the mandatory bid rules with shareholder cooperation see the UK Takeover Panel's Practice Statement (2009/26).

One way of encouraging shareholder cooperation would be to reduce the number of shareholders amongst whom cooperation is required. From this perspective, it might be good policy not to undermine blockholding, where it exists, but instead to concentrate on promoting effective protection of non-controlling shareholders. In dispersed public markets, policy might encourage private equity as a way of re-concentrating holdings of shares in the hands of a small number of people.

Question 18

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 and/or whether they apply a code of conduct? If so, how can this best be achieved?

We share the view that there are indications that the voting recommendations of proxy advisors are followed without explicit decision or deliberation by a large number of investors that make use of their services. On the other hand, institutional investors with large diversified portfolio are not able to exercise the voting rights in each of the companies in which they hold shares. In certain cases this may lead to concentrating decision making powers in the hands of just a few proxy advisors who have no residual interest in the companies concerned. The voting policies of proxy advisors are often obscure and deemed to be proprietary information, and leave little or no scope to take account of specific circumstances of individual companies. To the extent that the proxy advisor also renders related services, conflicts of interest may arise.

We call attention to the need for institutional investors to organise themselves in such a way that they can better follow up the voting process, and take deliberate stands in a larger number of investee companies, and further require from the proxy advisor the necessary guarantees that he is not conflicted.

That said, we believe that the proxy advisory activity requires coordinating efforts at the EU and national level in such areas as disclosure of conflicts of interest, information on voting policies and individual follow up in case of contested meetings. Proxy advisors may usefully develop a code of conduct containing explicit rules on these concerns. ESMA could also play a useful role in ensuring that these rules and requirements are followed up.

Question 19

Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

Following up on the answer to question 18, we believe that this conflict of interest should be avoided, and that proxy advisors should not provide consulting services to

investee companies in which they vote. The claim of some proxy advisors that such services are provided behind Chinese walls, by departments who are not in contact with those who provide voting advice to institutional investors, does not provide sufficient comfort against conflicts of interests, in particular when the company faces contested issues.

Question 20

Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors?

Please provide details (e.g. objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).

We agree that identification of the shareholders increases the level of interest transparency, would help internal company communication what could strengthen understanding of the board's action or provide for early criticism in case of disagreement. At least the company should be able to obtain the identity of its shareholders, *whether on a permanent basis, or more exceptionally in case of strain, e.g. in view of an impending takeover bid*. The lack of transparency enables circumventing national laws aimed at controlling excessive concentration of economic power, abuses of empty voting, tax evasion, etc. Not only the company boards but also the shareholders should be able to contact other shareholders, allowing them to undertake joint action when needed.

The present systems of multilayered depositories and intermediated securities holding is complicated, expensive and often inefficient as far as the exercise of voting rights are concerned. Cross-border voting by shareholders is not possible efficiently in the European Union, despite the Shareholders Rights Directive. Shareholders often are not informed about forthcoming shareholder meetings and cannot ensure that their votes are exercised through the chain of intermediaries. Typically therefore the voting rights remain unexercised.

Shareholders should be entitled to take part in the general meeting and cast their votes independently from any intervention of the securities depositary system. The depositary that is directly in contact with the ultimate beneficiary of the deposit should be obliged to deliver a certificate of entitlement enabling the beneficiary to take part in the meeting and cast his vote, give a proxy to whom he prefers or take cast his vote electronically in advance of the meeting. This would greatly simplify the present system and lay the responsibility for shareholder absenteeism where it belongs, i.e. with the shareholder himself. It would allow individual shareholders to support actions undertaken by engaging shareholders, if such is needed. On the other hand it would only require the bank to ensure that the shareholders securities are held somewhere in the chain, what he is expected to do in any case. Due to the strong cross-border nature of the subject,

measures will have to be undertaken at the European level and we therefore suggest that the work on a directive on legal certainty of securities holdings and dispositions is pursued with a sense of urgency.

In addition, and building on the infrastructure developed to facilitate cross-border voting, we believe a "light" form of proxy solicitation may be helpful in mustering support for engaged shareholders. We would recommend that such a system of proxy solicitation is set up across the EU, on the basis of EU regulation. This would mean that listed companies registered in Member States would be required to set up a specific function on their website where qualifying shareholders can place information relating to items on the forthcoming agenda and can seek proxies from other shareholders. Such a proxy solicitation system should be restricted to the provision of electronic information through the company's website, to avoid costly and time consuming communication through hard copies. The regulation of the proxy solicitation should also be light touch, without seeking maximum, formalistic disclosures. To avoid that the proxy solicitation system is used for short term activism, shareholders would qualify if they hold a certain number of shares for a certain period of time, for example between 1 and 5% of the company's share capital for a consecutive period of, say, at least one year. A qualifying shareholder who would use the system would be required to hold his shares at the date of the general meeting and to provide an explanation of his views at the meeting. Shareholders jointly holding the required number of shares during the required period should also qualify to use the system. This electronic system of proxy solicitation would require that listed companies facilitate voting on general meeting items on their website (either through a function on the website that provides for the voting itself, or through a link to a third party site who organises the electronic voting process for the company). If engaged shareholders would use such a system of proxy solicitation light this could also serve as an attractive alternative to proxy advisors for investors who find it difficult to analyse how to vote with a diversified portfolio of investments.

Question 21

Do you think that minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

This question opens up an area of regulatory concern which is way too wide to answer briefly in a submission to the Green Paper. Minority protection is part of company law arrangements in all Member States but typically in very different ways. It would require special and detailed legal and empirical analysis of what type of problems minority shareholders are faced with and which instruments of minority protection work best to deal with these problems and under what circumstances. Before suggesting any particular measure we believe the Commission could fruitfully request for a study to be undertaken into the various mechanisms of minority shareholder protection, the contexts in which they operate and the effects they have.

Question 22

Do you think that minority shareholders need more protection against related party transactions? If so, what measures could be taken?

Related party transactions belong to the most prevailing threat to the rights of minority shareholders. They appear at board level, creating a conflict between the company and a director, or depending on the ownership structure, at the level of the controlling shareholder. Although several jurisdictions provide for ex post redress – abuse of right, abuse of minority – ex ante instruments could help to restore the balance when that is needed. This raises the issue of the definition of “related party transactions” where the accounting rules may offer some orientation. However, some case – especially corporate opportunity cases – will not be subject to the accounting standards provision. Moreover, the scope should include transactions with *significant* or controlling shareholders

The European Corporate Governance Forum has recommended specific ex ante disclosure guidelines for related party transactions in its statement of 10 March 2011. The recommendation includes that transactions representing more than 5% of assets of the company or which have a significant impact on profits or turnover should have the additional requirement of being put to a shareholders vote for approval in a meeting in which the related party is precluded from voting. We endorse the recommendation made by the Forum and would only add that the independent members of the board of directors should be obliged to investigate the fairness of the conditions of any related party transactions, on the basis of reports submitted by independent experts, while these reports should be made public, or at least publicly accessible in case the related party transaction is to be disclosed ex ante. A conflicted director should not take part in the decision or in the vote.

We tend to think that this matter warrants EU intervention, in light of the cross-border nature of the investor protection that is to be afforded. The Commission could however consider to first present a Recommendation on related party transactions to Member States, which has the benefit that it can be adopted relatively quickly and would leave Member States discretion on how to incorporate the substance into their company law or securities law.

Question 23

Are there measures to be taken, and if so, which ones, to promote at EU level employee share ownership?

Employee share ownership is supported by different types of measures, including financial and tax rules, in several jurisdictions. This subject is largely a matter to be left to national regulations and especially negotiations between employers and employees. We call to the concern that employee ownership should not lead to a high level of risk concentration for employees, and that risk diversification remains necessary.

IV. Monitoring and implementation of Corporate Governance Codes

Question 24

Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

The “comply or explain” approach has played a useful role in the process of introduction of corporate governance principles in actual company practice. It has raised awareness about the complexity of the matter and the multiple, not-mutually exclusive forms of governance. It has avoided petrification of governance practices and allowed for experimentation, while offering an incentive for continuous improvement in practices and in taking a deliberate stand about possible alternative practices.

In some fields however, “comply and explain” has proved ineffective. This is especially the case with disclosure of remunerations that in several jurisdictions had to be imposed by law, and then later restricted under the pressure of the financial crisis. The introduction of an audit committee has also been dealt with in the law.

Moreover the technique itself has come under criticism, as not all companies lived up to the expected standard. In the 2009 Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, the “level and quality of information on deviations and the low level of shareholder monitoring” were identified (p.18) Therefore questions should be raised about methods to improve the existing model, by insisting on having more detailed, meaningful explanation on deviations from the code and stating in some detail the reasons for the deviation, while a process for verifying the truthfulness of the statements deserves recommendation.

It would be useful that the Commission explicitly recognises the importance of this matter by outlining the principles for a meaningful and verifiable explanation, and this in the form of a Europe wide recommendation. Such a recommendation should be based on the insights that public and private monitoring bodies set up in the different Member States have gained over the years.

Question 25

Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?

According to the present analysis, the board of directors is responsible for the disclosures, while some involvement of the auditors has been signalled, especially as references to factual data are concerned. The board evidently is conflicted in case deviating practices have to be explained. Levels of explanation are often low, and explanations are sometimes weak to inexistent. At the same time shareholders are often insufficiently engaged to ensure proper explanation of deviations. An external review and monitoring of application of the code and the quality of information is therefore necessary.

Actual practice has developed several forms of monitoring. In some Member States securities regulators have taken up a role in the monitoring of the application of the code, sometimes also reviewing the contents and quality of explanations given for deviations of the code. It may be that these regulators fill in the gap left in particular in jurisdictions where controlling shareholders dominate both the board and the general meeting, in which case the comply or explain mechanism may not yield sufficient pressure to ensure proper governance arrangements. However, we do not believe that the involvement of securities regulators in the monitoring of corporate governance codes should be promoted at EU level. In other Member States the dynamics of listed companies, in light of ownership structures and the role of the securities regulator, may be very different. Involving securities regulators in the monitoring of corporate governance codes has the effect of moving the code and its application from the debate with shareholders to a compliance discussion with the regulator. Applying the usual supervisory instruments such as mandatory replies to answers, in situ investigations, or sanctioning would undermine the debate with shareholders and the voluntary nature of the codes. Also, the quality of the explanation may come under threat if there would be a risk of legally enforceable sanctions.

In some Member States voluntary monitoring bodies have sprung up, mainly drawing up lists of compliant and deviating companies and practices. These bodies however suffer from a lack of legal recognition, limiting their role to observation and surveying implementation vs deviation, without a more in depth analysis of compliance and especially of non-compliance explanations.

Therefore it should be considered to support the role of these non-official monitoring bodies, by legally recognising their role as part of the “comply and explain” process. In some Member States it may help that such non-official monitoring bodies have the explicit support from public authorities, as is for example the case in The Netherlands. In other Member States this may not be feasible or may not prove to be effective and whether this is done should be left to Member States to decide.

Their oversight should be extended to a verification of compliance with the code provisions, in the sense that in case of *non-compliance* the monitoring body would

investigate the reasons for non-compliance and recommend action to ensure compliance or proper explanation. In case of obstinate refusal, the monitoring body could publish its opinion (“name and shame”). The right to publish should be provided in the law, in order to offer protection against libel law suits. In case of violation of the legal provisions, one could even consider the securities supervisor to be informed.

The verification of *compliance* could also be undertaken by the monitoring bodies, on the basis of extensive discussions with the company’s representative bodies. In order to ensure effectiveness, the panel analysing effective compliance should be composed of high level business leaders, familiar with business practices, assisted by corporate governance specialists. The organisation should be financed by the companies concerned.

Again, we believe that a Commission Recommendation could be helpful to promote meaningful monitoring activities by private monitoring bodies, based on consultation of the current monitoring bodies in the EU.

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