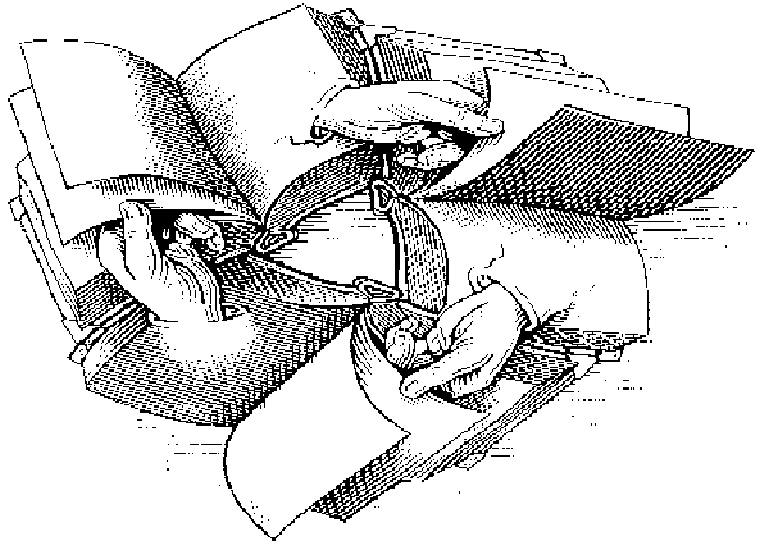
SZECSKAY
Attorneys at Law

Instituto Português de Corporate Governance



CGOV Meeting - Lisbon
September 19, 2011

The need to improve the corporate governance framework of European companies -Commission and Industry Views
Judit Budai

Introduction

- Green Paper on EU Corporate Governance published by the EU Commission on 5th April 2011
- Conceived in response to the financial crisis
- Expands corporate governance debate
- Published to generate a pan-European debate on corporate governance through a consultation process

Aims of the Presentation

- To outline the proposals of the Commission included in the Green Paper
- To highlight a selection of answers published by EU trade and industry bodies in response to the questions posed in the Green Paper by the Commission
- To raise awareness of prevailing viewpoints on certain issues without drawing conclusions

What is Corporate Governance ("CGov")?

- The Commission defines corporate governance in the Green Paper as the system by which companies are directed and controlled and is a set of relationships between a company's management, its board, its shareholders and its other stakeholders.

What is the current CGov Framework for EU-listed companies?

It comprises of:

- Legislation
- "Soft Law" – This includes Recommendations and Corporate Governance Codes

Corporate Governance Codes:

- Usually adopted at national level
- Reinforced by EU Statutory Audit Directive (2006/46/EC) requiring listed companies to report yearly on a 'comply or explain' basis

Deficiencies of the Self-Regulatory EU CGov Regime (Pre-Financial Crisis)

According to the Commission:

- It produced too much short-term thinking
- It allowed management to get away without challenges by boards
- It gave rise to potential conflicts of interest within institutional investors
- It produced excessive risk-taking
- It did not adequately engage shareholders in the governance of the companies that they own

A Newly Invigorated EU CGov Regime

According to the Commission:

Increased EU action to complement national corporate governance rules will:

- Properly reflect the cross-border nature of business within the European Union
- Help rebuild people's trust in the single market following the financial crisis
- Contribute to a strong and successful single market

Scope of the Green Paper

- It identifies key areas for improvement of listed companies which promote good corporate governance:

1. The diversity and mechanics of boards of directors
2. The engagement of shareholders
3. The monitoring and enforcement of existing national corporate codes and the quality of corporate governance statements

The Respondents

- The Green Paper is seen by the Commission as an opportunity to generate a broad debate, through a consultation process, on the effectiveness of the corporate governance framework for European companies

- In this presentation, the views of the following respondents to the GP are included:
  - The London Stock Exchange ('LSE')
  - The European Savings Banks Group ('ESBG')
  - The European Federation of Investors ('EuroInvestors')
  - European Private Equity and Venture Capital Association ('ECVA')
  - The UK's Financial Reporting Council ('FRC')
  - The European Confederation of Directors' Associations ('ecoDa')
  - The International Federation of Accountants ('IFAC')
  - The Investment Management Association ('IMA')
  - The Asset Management and Investors Council ('AMIC')
  - The Federation of European Risk Management Associations ('FERMA')
  - Council of the Bars and Law Societies of Europe ('CBBE')
  - Transparency International ('TI')

Preliminary Issues

The Green Paper deals with two preliminary issues:

1. If there should be a different proportionate corporate governance regime for small and medium-sized companies

2. Whether any corporate governance measures should be taken at EU level for unlisted companies

Question 1 – Should there be different CGov rules for smaller companies?

The possible advantage:

- Specific codes and provisions tailored to small and medium-sized companies could include recommendations that reflect company size and structure and, as such, would be easier to implement.

Question 1 – Should there be different CGov rules for smaller companies?

Responses:

- **LSE:**Thresholds would reduce the scrutiny of companies
- **ESBG:** Artificial discrimination of companies by size could mislead investors
- **EuroInvestors:** To protect shareholders, the same level of transparency and CGov should be applied to all listed companies
- **ECVA:** Rigidly applying the same mandatory guidelines and regulations across sectors and different sized companies could result in opportunity costs and opposite behaviours and effects to those desired

Question 1 – Should there be different CGov rules for smaller companies?

Responses:

- **EuroInvestors:** Companies who find the requirements too stringent could use a market where there is lighter regulation and a lower compliance burden – ie AIM, NYSE Alternext

- **General Response:** To maintain the regulation of corporate governance through a "Comply or Explain" basis

"Comply or Explain":

- Is flexible
- Is relevant and effective
- It would allow SMEs to adapt their governance models to their needs and business interests and to take a lighter approach where appropriate

Question 2 – Should there be CGov measures at an EU level for unlisted companies?

According to the Commission:

- Good corporate governance may also matter to shareholders in unlisted companies
- Currently there are gaps in national company law concerning certain CGov issues
- Proper and efficient governance is valuable for unlisted companies, especially when the economic importance of certain very large unlisted companies is considered

Question 2 – Should there be CGov measures at an EU level for unlisted companies?

Responses:

- **Generally:** No desire for mandatory EU measures for unlisted companies
- **FRC:** The need for CGov measures for unlisted companies is unnecessary. CGov ensures that companies are accountable to those that provide their capital. In unlisted companies, shareholders are insiders and much better able to hold management directly to account
- **LSE:** CGov allows management and shareholders to engage and communicate – good for widely dispersed equity holdings but unnecessary for small companies where shares are often concentrated

Question 2 – Should there be CGov measures at an EU level for unlisted companies?

Responses:

- General response is in favour of a voluntary and minimum form of governance for unlisted companies based on voluntary codes (such as ecoDa's). These would:

1. Provide benefits for minority investors in unlisted companies
2. Be voluntary, allowing companies to retain flexibility in developing the corporate governance
3. Provide flexibility to adapt if a company's governance requirements change over time
4. Through its flexibility, reflect the reality that there is an extremely wide range of private companies

The Diversity and Mechanics of 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?

According to the Commission:

- Boards of directors play a vital role in the development of responsible companies
- The role played by the chair person also has a considerable impact on the board's functioning and success
- In consideration of this impact, the Commission is seeking to more clearly define the position and responsibilities of the chairperson of the board

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?

Responses:

- **LSE and EuroInvestors:** Both agree there is a need for a clear division to prevent conflicts of interest and to prevent concentration of management powers

- **EVCA:** Does not believe that this should be regulated at an EU level – it is rather a question for national law or voluntary corporate codes

- **AFME:** Points out that there are advantages to combining the two functions, thereby consolidating the board process. Boards should be able to determine the appropriateness of a combined function

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?

Responses:

- **EVCA:** The severance of the roles of Chairman and CEO should be supported through a "comply or explain" disclosure regime

- **IMA:** A "comply or explain" approach gives companies flexibility to phase in any change over time. Ultimately, such a regime allows management to enjoy sufficient flexibility to run a company as they see best, whilst remaining fully accountable to shareholders

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?

According to the Commission:

- Composition of the board has to suit the company's business
- Diversity in the members' profiles and backgrounds gives the board a range of values, views and sets of competencies
- This can lead to a wider pool of resources and expertise

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?

According to the Commission:

- Different leadership experiences, national or regional backgrounds or gender can provide effective means to tackle 'group-think' and generate new ideas
- More diversity leads to more discussion, more monitoring and more challenges in the boardroom. It potentially results in better decisions
- The Commission found that companies acknowledged the importance of identifying complimentary profiles in selecting board members but that this was not common general practice

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?

Responses:

- **LSE:** It is important that the nomination committee of the board continuously evaluates the balance of skills, experience, independence and knowledge on the board, and considers this when looking to fill a particular role (see UK CGov Code)

- **ecoDa:** Also favours the code approach - board composition should be tailored to the specific circumstances of the company, its challenges, strategic ambition and time constraints

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?

Responses:

- **ecoDa:** "General recipes" cannot be developed at an EU level and rather tailoring through national codes should be the rule

- **LSE:** Broad principles on profiles may be applicable on an EU wide basis, but each member state should determine the details. Prescription at European level might lead to boiler-plate specifications that do not meet individual company needs

- **EVCA:** Agrees. Flexibility needs to be retained so that companies can hire the most appropriate and best qualified candidates for the board of directors

Question 5 – Should listed companies be required to disclose whether they have a diversity policy?

According to the Commission:

See Question 4.

Responses/Solutions:

- **ECVA:** The implementation of a "comply or explain" disclosure regime would contribute to greater transparency and would encourage companies to adopt diversity policies. However, it warns against increasing the reporting burden of listed companies too much

- **FRC:** Currently consulting on whether to introduce such a requirement into the UK CGov Code on the basis that it will encourage boards to attain the level of diversity which will strengthen their decision-making and risk oversight and limit the risk of “group think”

Question 6: Should listed companies be required to ensure a better gender balance on boards? If so, how?

According to the Commission:

- The proportion of women on the (supervisory) boards of listed companies in the EU is currently on average 12%
- Gender diversity can contribute to tackling group-think
- Studies suggest there is a positive correlation between the percentage of women in boards and corporate performance, highlighting the business case for gender balance in management and corporate decision-making

Question 6: Should listed companies be required to ensure a better gender balance on boards? If so, how?

According to the Commission:

- Promoting women to boards contributes to increasing the pool of talent available for a company's highest management and oversight functions
- The introduction of measures such as quotas or targets to ensure gender balance in boards is not sufficient if companies do not adopt diversity policies that contribute to work/life balance for women and men
- While companies should decide whether they introduce such a diversity policy, boards should at least be required to consider the matter and disclose the decisions that they have taken

Question 6: Should listed companies be required to ensure a better gender balance on boards? If so, how?

Responses:

- **ESBG:** Opposes any fixed ratios and specifications regarding gender balance laid down by legal provisions. These kinds of issues should be decided by every individual company based on its profile and strategy, and in the best interests of shareholders

- **ecoDa:** Doesn't see a need for regulatory intervention on board gender balance at EU level because numerous initiatives are already taken at national level

- **EuroInvestors/FRC:** Reiterated that the primary criteria to be taken into account during the non-executive board members recruitment process are the professional qualifications and competencies of the candidate

- **EVCA/ESBG:** Listed companies should be required to describe if they have a policy on board gender diversity, what it is and report against it. However, this would be achieved by again using a flexible "comply or explain" code at a national level

Question 7 –Should there be a measure at EU level limiting the number of mandates a non-executive director may hold and, if so, how should it be formulated?

According to the Commission:

- The role of non-executive directors has grown in complexity and importance
- This is reflected in a number of national corporate governance codes and legislation
- Limiting the number of mandates could be a simple solution to help ensure non-executive directors devote sufficient time to monitoring and supervising their companies

Question 7 –Should there be a measure at EU level limiting the number of mandates a non-executive director may hold and, if so, how it should be formulated?

Responses:

- **LSE:** Limiting the number of mandates would not be an effective way of ensuring that non-executive directors commit enough time to a role, because such commitments vary widely. Therefore, a quota would not equate to an effective time commitment

- **ESBG:** Agrees. Considers proportionate guidelines or recommendations according to a 'comply or explain' principle more appropriate than prescriptive rules in this area. A strict limitation of directorships is inappropriate

- **FRC:** Instead of limits, directors should disclose responsibilities entailing time commitments that might affect their ability to fulfil their responsibilities, and letters of appointment should set out the time commitment expected of each director

Question 8 – Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how this could be done?

According to the Commission:

- The Commission's 2005 Recommendation on the role of non-executive or supervisory directors of listed companies stated that the board should evaluate its performance annually
- Regular use of an external facilitator (e.g. every third year) could improve board evaluations by bringing an objective perspective and by sharing best practices from other companies
- At a time of crisis, or of a breakdown in communication between board members, an external reviewer really adds value to the evaluation
- To encourage openness, a degree of confidentiality should be maintained and that any evaluation statement disclosed should be limited to explaining the review process

Question 8 – Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how this could be done?

Positive Responses:

- **ECVA:** It is in favour of the EU encouraging external evaluation regularly for listed companies. However, any connection between an external evaluator and the company should be disclosed to the market

- **LSE:** It is appropriate for the boards of larger listed companies to submit themselves to external evaluation every three years. However, it would be disproportionate to require this for smaller companies, for whom it could be extremely expensive and disruptive

- **FRC:** The EU needs to improve its understanding of the appropriate scope of board evaluation and to strengthen the market in external evaluation. This can be achieved by adopting a best practice, code-driven approach

Question 8 – Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how this could be done?

Negative Response:

- **ESBG:** Voluntary self-assessment, i.e. self-evaluation, at appropriate intervals are sufficient. It is the responsibility of shareholders to choose supervisory board members and to evaluate their activities

Questions 9 and 10 – Should disclosure of remuneration policy, the annual remuneration report and individual remuneration of executive and non-executive directors be mandatory? Should the remuneration policy/report be put to a mandatory vote by shareholders?

According to the Commission:

- Corporate governance focuses on the issues which arise from separating ownership and control, in particular the principal-agent relationship between shareholders and executive directors

- Directors' remuneration has widely been used as a tool to align the interests of shareholders and executive directors and so reduce agency costs

- In recent years, variable remuneration, normally linked to performance and responsibilities, has become much more prevalent. However, a mismatch between performance and executive directors' remuneration has also come to light

Questions 9 and 10 – Should disclosure of remuneration policy, the annual remuneration report and individual remuneration of executive and non-executive directors be mandatory? Should the remuneration policy/report be put to a mandatory vote by shareholders?

According to the Commission:

- Poor remuneration policies and/or incentive structures may lead to unjustified transfers of value from companies and their shareholders and other stakeholders to executives
- A focus on short-term performance criteria may have a negative influence on long-term sustainability of a company

Questions 9 and 10 – Should disclosure of remuneration policy, the annual remuneration report and individual remuneration of executive and non-executive directors be mandatory? Should the remuneration policy/report be put to a mandatory vote by shareholders?

Responses:

- **LSE:** Supports this sort of disclosure and points out that it is mandatory in several Member States including the UK and Italy. However, it supports maintaining the shareholder vote on an advisory basis only (as in the UK)

- **ESBG:** Any such votes provided for under national governance "comply or explain" regimes should remain advisory. Provisions of the EU CRD 3, which came into force on 1 January 2011, specifically provides principles on sound remuneration

- **AMIC:** Asset managers aim to achieve repeat business - by achieving good performance over longer time. A principle-based approach to remuneration policies targeted at asset managers will ensure adequate flexibility

Questions 11 and 12 – Should the board approve and be responsible for a company's 'risk appetite' and report it to shareholders? Should the board ensure that a company's risk management arrangements are effective and commensurate with the co's risk profile?

According to the Commission:

- All companies face a wide variety of external or internal risks. As such, they should develop an adequate risk culture and arrangements to manage them effectively
- A 'one size fits all' risk management model for all types of companies is not possible. However, it is crucial that the board ensures a proper oversight of the risk management processes
- To be effective and consistent, any risk policy needs to be clearly 'set from the top' i.e. decided by the board of directors for the whole organisation
- It is indispensable to define clearly the roles and responsibilities of all parties involved in the risk management process: the board, the executive management and all operational staff working in the risk function

Questions 11 and 12 – Should the board approve and take responsibility for a company's 'risk appetite' and report it meaningfully to shareholders (including key societal risks)? Should the board ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?

Responses:

- **FERMA:** The board should include members with experience and awareness of risk management. The board, and senior executives, should be supported in these duties by operational management, risk management and compliance, and by the audit functions

- **IMAC:** The audit committee could be responsible for the detailed oversight of the company's risk appetite and future risk strategy and should report on this to the board. Reporting to shareholders should strike a balance between providing meaningful information on which to base investment decisions, and investment protection, which requires confidentiality

- **LSE:** Supports a high level of disclosure of information to shareholders, BUT companies should not be mandated to do so, because it may put them at a disadvantage to peers

Questions 11 and 12 – Should the board approve and take responsibility for a company's 'risk appetite' and report it meaningfully to shareholders (including key societal risks)? Should the board ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?

Responses:

- **FERMA:** Supports the Commission's view. The existing national corporate governance legal framework on the obligation to communicate risks suggests that positive communication should be encouraged

The Engagement of Shareholders

According to the Commission:

- A lack of appropriate shareholder interest in holding financial institutions' management accountable contributed to poor management accountability and facilitated excessive risk taking in financial institutions
- This is also relevant to shareholder behaviour in listed companies with dispersed ownership
- In companies with a dominant or controlling shareholder, the (economic) interests of minority shareholders must be adequately protected

Question 13 – Do any existing EU legal rules contribute to inappropriate short-termism among investors and, if yes, how could these rules be changed?

According to the Commission:

- Shareholder engagement involves actively monitoring companies, engaging in a dialogue with the company's board, and using shareholder rights to improve the governance of the investee company in the interests of long-term value creation
- It is primarily long-term investors who have an interest in engagement
- Some of the reasons for a lack of shareholder engagement, such as the cost of engagement, seem to have an impact on most institutional investors
- Institutional investors, including asset owners and managers, should be required to publish their voting policies and records

Question 13 – Do any existing EU legal rules contribute to inappropriate short-termism among investors and, if yes, how could these rules be changed?

According to the Commission:

- There could be a framework for transparency in voting policies and disclosure of general information about their implementation while respecting the equal treatment of shareholders

- Major developments in capital markets have mostly focused on the trading function of the capital markets and facilitated faster and more efficient trading innovations, increasing liquidity but also helping to shorten shareholding periods

- Some investors have also complained of a 'regulatory bias' towards short-termism, which hinders long-term investors from adopting longer-term investment strategies

- Solvency and pension fund accounting rules, intended to promote greater transparency and more effective market valuation, made unintended consequences

Question 13 – Do any existing EU legal rules contribute to inappropriate short-termism among investors and, if yes, how could these rules be changed?

ecoDa Response:

- It points to the potential drawbacks of the business model of modern 'commercial' capital markets
- The efficient operation and profitability of stock exchanges is a crucial driver - the bulk of their business income stems from the trading function
- High frequency, automated trading and sufficient liquidity are very important
- This transaction-based business model clearly helps to promote shorter shareholding periods - more attention should be paid to these 'unintended' consequences
- Special attention should be paid to the impact of the IFRS rules

Question 13 – Do any existing EU legal rules contribute to inappropriate short-termism among investors and, if yes, how could these rules be changed?

Other Responses:

- **FRC:** The Markets in Financial Instruments Directive (MIFID) appears to have stimulated greater interest among market participants in trading strategies. This plays to the commercial interests of investment banks because of their dependence on dealing profits

- **EuroInvestors:** MiFID has marginalised individual shareholders (who are mostly long term holders) by severely reducing the pre- and post-trade transparency for them, by fragmenting and making equity markets much more complex for the benefit of financial investors to the detriment of individual shareholders

Question 13 – Do any existing EU legal rules contribute to inappropriate short-termism among investors and, if yes, how could these rules be changed?

LSE Response:

- The activities of short-term investors should not be confused with those of automated traders and HFTs
- Intra-day, intermediary trading activity rarely leads to a substantial change in the register of a company, and therefore to a change in beneficial ownership. This is because intermediaries rarely hold the shares through to settlement
- It disagrees with the use of share turnover statistics, as used by the Bank of England, as a proxy for average holding durations
- It would be more appropriate to consider the turnover of beneficial ownership
- Initial analysis of company share registers shows that in 2011, 83 per cent of investors turned their portfolio over less than once every two years.
- This shows the skewed nature of share turnover data in calculating average holding periods, and the long-term nature of many fund managers

Question 14 –What additional measures to better align the interests of long-term institutional investors and asset managers are appropriate? Which measures should be taken with regards to the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

According to the Commission:

- Not all investors need to engage with investee companies
- However, the agency relationship between institutional investors (asset owners) and their managers contributes to capital markets' increasing short-termism and to mispricing
- The way asset managers' performance is evaluated, along with the incentive structure of fees and commissions, encourage asset managers to seek short-term benefits
- Short-term incentives in asset management contracts may contribute significantly to asset managers' short-termism, which probably has an impact on shareholder apathy
- There is support for the idea of greater disclosure of the incentive structures for asset managers

Question 14 –What additional measures to better align the interests of long-term institutional investors and asset managers are appropriate? Which measures should be taken with regards to the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

Responses:

- **LSE:** Unaware of any evidence that suggests that asset managers are incentivised to churn their portfolio and seek short-term benefit. The type of fund should also be considered. Greater transparency on incentive structures would be ideal, but there does not seem to be a case for further regulation

- **ESBG:** Asset management is an investment service under MiFID. Provision of this investment service is subject to the conflict of interest rules stipulated by MiFID. Therefore, these rules are sufficient and no additional rules are needed

- **IMA:** The manager's fee increases if the client gives him more money to manage or if the value of the portfolio increases. This aligns the manager's interests with those of the client. The incentives are designed to retain the business of the client on a long term basis

Question 14 –What additional measures to better align the interests of long-term institutional investors and asset managers are appropriate? Which measures should be taken with regards to the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

Opposite Response:

- **FRC:** Greater transparency is needed to ensure that alignment is appropriate

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?

According to the Commission:

- More transparency about the performance of fiduciary duties by asset managers could show whether or not asset managers' activities are beneficial for long-term institutional investors and long-term value creation on their behalf

- Information about the level of and scope of engagement with investee companies that the asset owner expects the asset manager to exercise, and reporting on engagement activities by the asset manager, could be beneficial

- More transparency on these issues would help institutional investors to better monitor their agents and thus have a greater influence on the investment process

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?

Responses:

- **LSE:** Legislative measures are likely to prove ineffective, given the differing cultures and practices throughout the EU's markets

- **ESBG:** It is not effective to impose the monitoring of asset managers by institutional investors through regulation. The EU legal framework should focus on achieving profit from a permanent and long-term perspective. How to monitor the activities of asset managers should be left to the investors themselves. There should be a fully effective comply-or-explain regime

- **IMA:** Such an EU law is not required because investment managers owe their duty to their clients. It also calls for a code-based approach, highlighting the UK's new code which sets out best practice for institutional investors

Question 16 –Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are any other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

According to the Commission:

- Conflicts of interest in the financial sector seem to be one of the reasons for a lack of shareholder engagement

- Conflicts of interest often arise where an institutional investor or asset manager, or its parent company, has a business interest in the investee company

Question 16 –Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are any other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

Responses:

- **LSE:** Numerous codes of best conduct already deal with the issue of conflicts of interest – The Stewardship Code in the UK and the Assogestioni Code in Italy provide for ways in which conflicts must be managed and disclosed

- **IMA:** Sees no need for additional measures. On the EU level, MiFID seeks to prevent conflicts of interest from adversely affecting the interests of its clients and sets out detailed requirements on the implementation of conflict of interest policies.

Question 16 –Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are any other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

Responses:

- **FRC:** The Code approach is a good starting point, but the ability of institutions to manage conflicts needs to be monitored closely, along with the effectiveness of existing regulatory requirements such as those in MIFID and the AIFMD kept under review

Question 17 – What would be the best way for the EU to facilitate shareholder cooperation?

According to the Commission:

- Individual investors may not always engage successfully
- Shareholder cooperation could help them to be more effective
- Clearer and more uniform rules on acting in concert would be beneficial in this respect
- Other ways in which shareholder cooperation could be facilitated include the setting up of shareholder cooperation fora or by an EU proxy solicitation system
- Some investors have expressed concern that cross-border voting is still problematic and should be facilitated by EU legislation
- The Shareholders' Rights Directive (2007/36/EC) improved this situation considerably but late transposition of the directive by many Member States means that the real impact for the individual end investor is only now becoming apparent

Question 17 – What would be the best way for the EU to facilitate shareholder cooperation?

EuroInvestor Response:

- Despite the adoption of the 2007 European Shareholders Rights Directive, there are still hurdles that individual investors face in exercising their voting rights that prevent shareholder engagement (especially cross-border)
- It blames poor performance of the Intermediaries' chain for making it difficult and costly for small shareholders to exercise their voting rights and for issuers to know who their real ('beneficial') owners are
- This in turn can prevent proper communication between issuers and shareholders
- The technologies used by the Intermediaries' chain are antiquated, with an absence of cross-border internet voting in all EU Member States
- General Meetings communications between listed issuers and their shareholders should not be monopolized by bank affiliates as this is not their core business and their track record in this business is not satisfactory.
- Shareholder identification and record services (notary public type) should be unbundled from share voting services

Question 17 – What would be the best way for the EU to facilitate shareholder cooperation?

EuroInvestor Response:

- To encourage shareholder engagement and to promote shareholders using their voice in European companies, Euroshareholders (a member of EuroInvestors) established a web based platform called EUROVOTE. This is aimed at facilitating cross-border voting
- Investor benefits of EUROVOTE include cost and time reduction, free expertise from representatives of shareholder associations, alignment of interests between investors and the proxy holders and stronger influence on company management.
- It is also beneficial for issuers because it provides better and direct (without intermediaries) contact with thousands of private shareholders via the national member associations and additional voting potential (increased turnout at GMs)
- Increased financial support for these shareholder associations would encourage shareholder engagement and cooperation and the balanced representation of individual shareholders vis-à-vis the financial industry at an EU level and cross border

Question 17 – What would be the best way for the EU to facilitate shareholder cooperation?

Other Responses:

- **CBBE:** There is currently a legal limit to cooperation between shareholders, because for listed companies, exchange of information that takes the form of a common policy could be treated as „acting in concert" with the consequences that this entails. To facilitate shareholder cooperation, it would be desirable, for the sake of legal certainty, to have a 'negative definition' of „acting in concert" at the EU level, specifying situations which do not constitute "acting in concert"

- **Other respondents:** Also encourage the Commission to address this issue and present it as a common barrier to greater shareholder cooperation at this stage

Question 17 – What would be the best way for the EU to facilitate shareholder cooperation?

ESBG Minority View:

- The facilitation of shareholders cooperation does not necessarily need to be regulated at the EU level. Shareholders are already able to effectively cooperate if they are interested in such cooperation in order to achieve their business interests.
- It thinks this is true as long as companies:

1. ensure equal treatment and protection of shareholder rights
2. take measures to encourage shareholders to participate actively in the work and decisions of the shareholder meeting and
3. provide comprehensive and timely information to the shareholders on all issues of importance for the realization of their rights and status

the necessary premises for shareholder cooperation are already in place

Question 18 and 19– Should EU law require proxy advisors to be more transparent? Furthermore, are other (legislative) measures necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

According to the Commission:

- Institutional investors with highly diversified equity portfolios face practical difficulties in assessing in detail how they should vote on items on the agenda of the general meetings of investee companies

- They make frequent use of the services of proxy advisors, so proxy advisors have a substantial influence on voting

- Institutional investors rely more heavily on voting advice for their investments in foreign companies than for investments in their home markets. As a result, the influence of proxy advisors would be greater in markets with a high percentage of international investors

Question 18 and 19– Should EU law require proxy advisors to be more transparent? Furthermore, are other (legislative) measures necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

According to the Commission:

- Investors and investee companies share concerns that proxy advisors are not sufficiently transparent about the methods applied with regard to the preparation of the advice
- Proxy advisors are subject to conflicts of interest
- The lack of competition in the sector raises concerns

Question 18 and 19– Should EU law require proxy advisors to be more transparent? Furthermore, are other (legislative) measures necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

Responses:

- **LSE:** The Shareholders Rights Directive (2007/36/EC) has improved best practice and the management of conflicts of interest for proxy advisors. However, the quality of advice from proxy advisors can vary. Furthermore, listed companies are not given an adequate opportunity to discuss voting reports with the advisors before publication. A code of conduct covering agreed behaviours, good working practices, management of conflicts and that promotes transparency would be beneficial

- **EuroInvestors:** An EU Code of Conduct should include a recommendation to proxy advisors to abstain from providing consulting services to companies and to disclose any potential conflicts of interest. It should also differentiate between commercial proxy advisors and shareholder associations

Question 18 and 19– Should EU law require proxy advisors to be more transparent? Furthermore, are other (legislative) measures necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

Responses:

- **CBBE:** Proxy advisors should not be allowed to provide advice and make recommendations for the same company. However, the coexistence of analysis and advisory activities should nevertheless be permitted in some circumstances. It is important to promote dialogue between agencies and issuers, which could develop through the introduction of the adversarial principle in developing recommendations

- **FRC:** Favours a disclosure regime, but is wary of regulations that would give issuers the power to delay publication of proxy adviser' reports or influence their content, because it would undermine the independence and usefulness of the advice

Question 20–Is there 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, would it also benefit cooperation between investors?

According to the Commission:

- There have been demands recently for EU action to increase the level of investor transparency towards issuers of shares
- Identifying their shareholders will enable issuers to engage in a dialogue with them. This could increase the involvement of shareholders in the companies they invest in
- Two thirds of Member States have already granted issuers the right to know their domestic shareholders
- The Transparency Directive and related national implementation measures provide for a degree of transparency of holdings above a certain threshold

Question 20–Is there 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, would it also benefit cooperation between investors?

According to the Commission:

- Others disagree with the demand to create a European tool for shareholder identification, due to the facilitation of modern means of communication
- Better knowledge of shareholders could also lead to management entrenchment
- In certain Member States there may also be privacy considerations related to data protection rules forbidding intermediaries to pass on information on shareholders

Question 20–Is there 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, would it also benefit cooperation between investors?

Responses:

- **LSE:** Greater convergence in the ability of issuers to identify the beneficial owners of their shares would be positive for corporate governance standards in the EU. Powers are currently available in some member states for issuers to identify the beneficial owners of shares (s.793 UK Companies Act 2006). This right and process should be implemented across the EU

- **EuroInvestors:** Agrees. It is important that this personal information is well protected from any kinds of abuse and will not be used for commercial purposes. Shareholders should have the possibility not to be identified in case of small shareholdings

Question 20–Is there 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, would it also benefit cooperation between investors?

Responses:

- **FRC:** Agrees. The right approach would be electronic registration of shares within a central depository, although this raises privacy issues. However, it is concerned that under the present system custodians appear to maintain no real time records of ownership and reconcile positions in omnibus accounts relatively infrequently

- **CBBE:** A European provision authorising central custodians from Member States to send requests to all custodians throughout Europe would enable issuers to have a deeper understanding of their shareholders – see the TPI. To promote cooperation between shareholders, issuers might consider giving their shareholders an identification key with secure codes allowing them access to a discussion forum

Question 21–Do minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

According to the Commission:

- Minority shareholder engagement is difficult in companies with controlling shareholders
- It questions whether the 'comply or explain' system is viable in such companies, particularly where adequate protection of minority shareholders is not guaranteed
- It questions whether the existing EU rules are sufficient to protect minority shareholders' interests against potential abuse by a controlling shareholder (and/or the management)

Question 21–Do minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

According to the Commission:

- Minority shareholder engagement can be particularly challenging in companies with a dominant or controlling shareholder who is typically also represented on the board

- The difficulties or inability of minority shareholders to efficiently represent their interests in companies with controlling shareholders may make the 'comply or explain' mechanism much less effective

- To enhance the rights of shareholders, certain Member States (e.g. Italy) reserve the appointment of some board seats to minority shareholders

Question 21–Do minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

Responses:

- **LSE:** Current measures are sufficient. It points out that the Shareholder Rights Directive implemented important measures to protect minority shareholders. Furthermore, existing law in some Member States prevents one shareholder from building up a dominant position without having to make a bid for the company

- **ESBG:** The current legal framework of the Member States ensures basically the balance of rights between minority shareholders and major shareholders and avoids both abuse of minority rights and abuse of majority rights within companies

Question 21–Do minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

Contrary EuroInvestor Response:

- Requests the proper recognition of individual shareholder associations by issuers and by the EU regulations. Shareholder associations should have the right to collect proxies, and to present resolutions to the general meetings once they reach a minimum percentage of shares through the proxies they collect

- Once a minimum percentage of shares is “free float” (e.g.30%) or there is a single majority shareholder, minority shareholders should get at least one board seat to protect their rights.

- An EU wide collective redress scheme for individual investors is also lacking

Question 21–Do minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

CBBE Response:

- Rights of minority shareholders should fall to Member States. So that controlling shareholders do not have a disproportionate voice in the direction of the company, the problem is not actually to represent 'minority shareholders' as such, but to ensure that:

1. All company directors have the responsibility to represent the collective interest of all shareholders, and not just one of them.
2. Minority shareholders should also vote to reduce absenteeism. The European legislature should encourage postal voting or through a proxy. Indeed, minority shareholders absenteeism allows some shareholders to exert de facto control over general meetings

Question 22–Do minority shareholders need more protection against related party transactions, and if so, what measures could be taken?

According to the Commission:

- Controlling shareholders and/or boards can extract benefits from a company to the detriment of minority shareholders' interests in many ways, the main way being through 'related party' transactions
- EU rules cover some aspects of related party transactions, accounting/disclosure
- Some believe that disclosure of related party transactions is not enough

Question 22–Do minority shareholders need more protection against related party transactions, and if so, what measures could be taken?

According to the Commission:

- There have been suggestions that, above a certain threshold, the board should appoint an independent expert to provide an impartial opinion on the terms and conditions of related party transactions to the minority shareholders

- Furthermore, significant related party transactions would need approval by the general meeting, and the publicity associated with general meetings might dissuade controlling shareholders from some transactions and give minority shareholders the chance to oppose the resolution approving the transaction

- Some propose that controlling shareholders should be precluded from voting altogether

Question 22–Do minority shareholders need more protection against related party transactions, and if so, what measures could be taken?

Responses:

LSE: There are current safeguards in place in the EU, in particular in Directive 78/660/EEC. However, requirements in certain member states go further than the requirements within the Directive. It gives the example of the Listing Rules in the UK and suggests that these requirements should be applied more widely

EuroInvestors: Believes it is very important to protect minority shareholders against related party transactions. This can be achieved at an EU level by obliging issuers to provide a report together with the Annual Report on all transactions undertaken with the major shareholder(s) during the fiscal year.

Question 22–Do minority shareholders need more protection against related party transactions, and if so, what measures could be taken?

Responses:

- **CBBE:** Several measures would help to regulate related party transactions and risks they may cause:

1. These agreements should be subject to prior authorisation before being concluded and any interested parties should not be able to take part in voting
2. An independent expert should draft a report for the most significant transactions
3. Furthermore, before adopting any measure on the matter, the European Union should ensure that rules governing related party transactions can be implemented in practice. These rules could at least be made by way of a Recommendation

- **IMA:** The EU should adopt the European Corporate Governance Forum guidelines

Question 23–Should measures be taken, and is so, which ones, to promote employee share ownership at an EU level?

According to the Commission:

- Employees' interest in the long-term sustainability of the company for which they work is an element that a corporate governance framework should account for
- Employees' involvement in the affairs of a company can relate to forms of financial involvement, particularly to employees becoming shareholders
- Employee share ownership has a long tradition in some European countries and that such schemes are mainly considered as means to increase the commitment and motivation of workers, raise productivity and reduce social tension
- Employee share ownership does involves risks from lack of diversification
- However, employees as investors could play an important role to increase the proportion of long-term-oriented shareholders

Question 23–Should measures be taken, and is so, which ones, to promote employee share ownership at an EU level?

Responses:

- **LSE:** Employees should be encouraged to become shareholders. However, this should be based on good voluntary corporate governance, and not mandated

- **ECVA:** In order to encourage employee share ownership, the focus should lie on incentives which are based on the shares retention period. One of the most efficient instruments for this purpose is tax incentives with the aim to enhance employee share ownership by way of a tax shelter when purchasing the shares

- **FRC:** European company law already provides for employee share schemes and for employees to be consulted. There is no need for further measures in this area . It warns against a large emphasise on employee share ownership, because it will not necessarily lead to greater long termism (example of Lehman Brothers)

Question 23–Should measures be taken, and is so, which ones, to promote employee share ownership at an EU level?

EuroInvestors Response:

- Refers to the measures that have been in place in France for decades, which have resulted in a large development of the employee share ownership.

- The development of employee share ownership as positive provided that:

1. Employee shareholder rights are not confiscated or limited by issuers
2. Employees' shareholdings of the company they work for remain a limited percentage of their total savings in order to diversify the risks, as their salary is already subject to the same company's failure risk (Examples of the Enron case in the US and Vivendi in France)

The ‘Comply or Explain’ Framework – Monitoring and Implementing Corporate Governance Codes

According to the Commission:

- Surveys among companies and investors show that most of them consider ‘comply or explain’ approach as an appropriate tool in corporate governance
- This has been demonstrated in most of the responses that have been surveyed in the preparation of this presentation
- A company which chooses to depart from a corporate governance code recommendation must give detailed, specific and concrete reasons for it
- Its main advantage is its flexibility - it allows companies to adapt their corporate governance practices to their specific situation
- It makes companies more responsible by encouraging them to consider if their corporate governance practices are appropriate and by giving them a target to meet

The ‘Comply or Explain’ Framework – Monitoring and Implementing Corporate Governance Codes

According to the Commission:

- The introduction of the ‘comply or explain’ approach in the EU has had difficulties
- A study revealed important shortcomings in applying 'comply or explain' principles that reduce the efficiency of the EU’s CGov framework and limit the system’s usefulness
- Some adjustments appear necessary to improve the application of the corporate governance codes.
- The solutions should not alter the fundamentals of the ‘comply or explain’ approach but contribute to its effective functioning by improving the informative quality of the reports
- These solutions are without prejudice to the possible need to reinforce certain requirements at EU level by including them in legislation

Question 24–Should companies departing from the recommendations of corporate governance codes be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

According to the Commission:

- The overall quality of companies' corporate governance statements when departing from corporate governance code recommendations are unsatisfactory
- In over 60% of cases where companies chose not to apply recommendations, they did not provide sufficient explanation
- A slow improvement in this field can already be observed. However, further improvement could be achieved by introducing more detailed requirements for the information to be published by companies departing from the recommendations
- It would be appropriate to require that companies not only disclose the reasons for departure from a given recommendation, but also give a detailed description of the solution applied instead

Question 24–Should companies departing from the recommendations of corporate governance codes be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

Responses:

- **ecoDa:** More conscious reflection on each principle and its implementation in practice should lead to more specific and tailored reactions per company. It is appropriate that, besides the explanation for non-compliance, there is also disclosure of the alternative solution that has been adopted

- **EuroInvestors:** Companies departing from recommendations of corporate governance codes should be obliged to provide detailed explanations for such departures and describe the alternative solutions adopted

Question 24–Should companies departing from the recommendations of corporate governance codes be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

Responses:

- **ECVA:** Agrees that explanations should be given where the Code recommendations are not followed, but there should not be prescription on detail because the significance of departures will vary considerably. An explanation for departure combined with a description of alternative solutions should be framed in a way that allows for flexible reporting. A 'comply and explain' approach ensures that best practices are adopted –it has a very strong self-regulatory effect

- **ESBG:** The principle is already in place in numerous Member States in which the obligation for companies to provide explanations in cases of non-compliance (including the reasons therefore) is already a legal requirement. The 'comply-or-explain' approach represents the appropriate framework for the functioning of Corporate Governance Codes

Question 25 Should monitoring bodies be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary?

According to the Commission:

- Corporate governance statements that companies publish seem not to be monitored as they should be
- In most Member States, responsibility for enforcing the obligation to publish is left to investors who often take little action
- Financial market authorities or stock exchanges and other monitoring bodies work within different legislative frameworks and have developed different practices

Question 25 Should monitoring bodies be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary?

According to the Commission:

- Few Member States have public or specialised authorities checking the completeness of the information provided
- 'Comply or explain' could work much better if monitoring bodies were authorised to check whether the available information is sufficiently informative and comprehensive
- One way to improve monitoring could be to define the corporate governance statement as regulated information within the meaning of Article 2(1)(k) of Directive 2004/109/EC

Question 25 Should monitoring bodies be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary?

Responses:

- **LSE:** Separate monitoring bodies should not be authorised to check the quality of explanations. It is the responsibility of shareholders, as owners of the company, to ensure that explanations are sufficient. Such an approach could create conflicts where shareholders deem an explanation sufficient, but the monitoring body does not. Such bodies should have an advisory role

- **ESBG:** Concurs. It does not agree with having EU rules empowering monitoring bodies to check the corporate governance statements. Regulatory authorities, under a "comply or explain" feature, should limit their role to checking the existence of the statement. More thought should be given to the principles of subsidiarity and proportionality

Question 25 Should monitoring bodies be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary?

Opposite Responses:

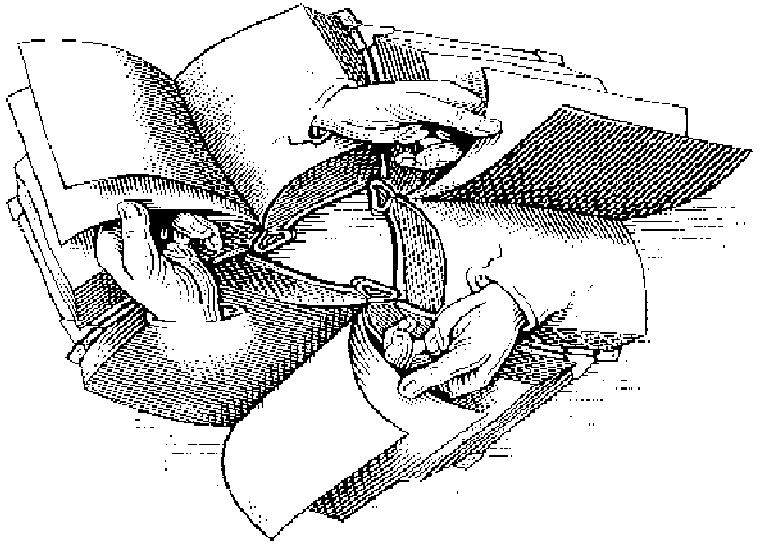
- **EuroInvestors:** Financial supervisory authorities should be responsible for making sure that the 'comply or explain' framework is properly enforced. They should dispose both of injunctive and sanction powers and the informative quality of explanations in the corporate governance statements should be first verified by the auditor

- **TI:** Authorising appropriate monitoring bodies to check such statements and request further information would minimise the incentive to deviate from good practice in corporate governance and ensure the quality of information necessary for monitoring organisations to fulfil their role. This should be part of a broader suite of appropriate sanctions and penalties available to regulatory and monitoring authorities to ensure compliance with accepted corporate governance standards

Next Steps

- The consultation period ended on the 22 July 2011
- On the basis of the responses received, the Commission will take a decision on the next steps
- Any future legislative or non-legislative proposal will be accompanied by an extensive impact assessment taking into account the need to avoid disproportionate administrative burden for companies

SZECSKAY
Attorneys at Law
www.szecskay.hu



Thank you for your attention !