European Shadow Financial Regulatory Committee

Corporate Governance In Europe

Statement No. 15

London, December 2, 2002

1 Recent scandals and the regulatory response

Recent events in the US such as the Enron and WorldCom scandals, as well as difficulties in European companies such as Vivendi, have brought issues in corporate governance back to the fore. In the US, the Enron debacle has inter alia triggered a number of legislative initiatives (such as the Sarbanes-Oxley Act of July 2002). The need for better corporate governance in the EU, and the means of achieving it, are the subjects of this statement from the European Shadow Financial Regulatory Committee (ESFRC). Background includes the November 2002 report by the High Level Group of Company Law Experts, chaired by Jaap Winter (the Winter Group). One motivation[1] for their report is to "co-ordinate and strengthen efforts undertaken by and within Member States to improve corporate governance". The immediate objectives of the Winter Group are improving shareholder protection and restoring confidence in the system, which was shaken by the recent events. But the Winter Group also focus on improving efficiency and competitiveness of EU firms, aiding in the development of the Single Market and facilitating and empowering growing cross border investment.

Our approach to selected issues in EU corporate governance takes on two dimensions. First, we seek to assess whether self-regulation by firms is adequate to ensure sound corporate governance or whether regulation by statute is needed. Second, in the case that self-regulation by firms or the private sector is insufficient, we aim to assess whether EU-wide legal harmonisation or national rules are the best locus of regulatory action. We also highlight the existing diversity in corporate governance among states, and that there is no clear "best type" of governance towards which Europe should be moved by regulation rather than market forces. A corollary is that EU countries should not simply fall in line with the US approach but there should be a broad EU-US agreement of rules. Before going into more detail, we seek to provide a definition of corporate governance from a formal and an economic point of view.

2 What is corporate governance?

We may distinguish between a *formal definition* of corporate governance and why it is needed in an economic sense. Corporate governance is not clearly defined in the

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[1] The new report issues recommendations for legislation and other EU initiatives in the areas of Corporate Governance, Capital Formation and Maintenance, Groups and Pyramids, Corporate Restructuring and Mobility, The European Private Company, and Co-operatives and Other Forms of Enterprises.

Winter Report, beyond it being "a system, having its foundations partly in company law and partly in the wider laws and market structure". Governance in general has to do with the issue of allocation of power on the one hand (what powers and to whom) and the issue of the exercise of power on the other (the question of how power is exerted, processes and procedures, accountability and responsibility.) Meanwhile, companies are usefully seen as a framework for co-operation where contracts are incomplete, and in this context the relevant aspect of power relates to decisions that determine future returns and their distribution across claimants on the firm. Accordingly, corporate governance has to do with the way in which decisions over claims are taken in a company (powers of managers and shareholders) and with the corresponding issue of accountability and transparency with respect to decisions taken. These issues are often determined by company law, as well as securities laws, accounting rules and practices, history and politics.

As regards the *economic rationale for corporate governance*, the separation between ownership and control in the modern corporation leads to the result that shareholders cannot perfectly control managers acting on their behalf. Underlying factors are asymmetric information, inability to write contracts covering all contingencies, the discretionary nature of dividend payments and the sheer lack of skills and resources to second-guess managers. Hence, principal-agent problems arise. Managers have superior information about the firm and its prospects, and at best a partial alignment of their interests with the goal of profitability. Consequently, they may direct resources to the disadvantage of shareholders.

A key to all successful forms of corporate governance is mechanisms for legal protection of shareholders. These include the right to vote on important corporate matters, as well as elections of boards of directors. Boards of directors, in particular independent directors, act as representatives of shareholders and (in some countries) other stakeholders in monitoring management. Disclosure and transparency are also essential, not only to enable shareholders to cast votes accurately, but also so that market prices will accurately reflect value, enabling dissatisfied shareholders to exit the firm. A related aspect is of course the willingness and ability of other firms to buy shares from equity holders of under-performing firms, to take over the firm and to change the management.

Effectiveness of ongoing corporate governance may also be enhanced by large investors, be they banks, other companies, or institutional investors. They will have the leverage to oblige managers to distribute profits to providers of external finance. They are needed because individual investors may find it difficult to enforce their rights, even if these are legally enshrined. Large investors may find it easier than small investors to enforce their rights in court. On the other hand minority holders may need protection against exploitation by "blockholders", an area where independent board members may play an important role.

3 Procedures for improving corporate governance in the EU

There is great diversity in company law and other areas affecting corporate governance within the EU and the diversity will increase further with enlargement in the next few years. It is therefore of great importance for the EU to develop procedures for corporate governance reform which recognise the diversity among states, as well as the diversity of legal areas affecting corporate governance.

With respect to procedures, the Winter report recommends that the Commission should give priority to preparing “a Company Law Action Plan which sets the EU agenda, with priorities for regulatory initiatives…”, and to “the setting up of a permanent structure to provide the Commission with independent advice on future regulatory initiatives…”. The Winter Group is obviously inspired by the Commission’s initiatives in the area of financial services sector to develop a Financial Services Action Plan, and the Lamfalussy report. We are concerned that the action plans as well as the type of permanent advisory structures advocated are likely to have an automatic bias in favour of harmonisation. The ESFRC raised this point in its Statement No. 10.

We recommend that the Commission and other EU institutions take clear positions on (i) principles for the use of harmonisation versus subsidiarity of legislation and regulation, and (ii) principles for the use of binding directives vs recommendations and other non-binding means, including private initiatives, for achieving common standards.

It is our view that harmonisation efforts should largely be constrained to focus on mobility enhancing legislation eliminating explicit hindrances to mobility, as well as government sanctioned discrimination of firms and individuals from different countries. Mobility and non-discrimination lead to competition among national institutional structures and thereby may over time lead to a degree of harmonisation by market forces. In this regard, the Winter report rightly emphasises that hindrances to corporate choice of jurisdiction of incorporation should not be accepted. Such hindrances weaken competition in the area of company law.

Additional criteria for positive harmonisation include a “race to the bottom”. However, there is little evidence of such races in the area of company law, and corporate governance more generally. Furthermore, a case for harmonisation can be made to enhance the competitive mechanism, for example in the area of information disclosure. There are also areas of company law wherein competition among legal and regulatory structures work only very slowly. Market forces could then be “helped along” by EU initiatives, for example in the case of conflicts of interest between shareholders and management.

Increased use of recommendations by EU could speed up the voluntary adoption of “good practices” (self-regulation), and these practices could be allowed to vary across countries. Recommendations would also make it possible to “test” regulation and legislation in member states that adopt them early before directives are formulated.

Clarifying the focus of the permanent structure envisaged in the Winter Report, we suggest the setting up of a committee including representatives of all EU countries to co-ordinate national responses to US initiatives such as the Sarbanes-Oxley Act that threaten European’s firms’ access to American securities markets. Coordination in Europe across different areas of law and regulation could also be a task of the new committee.

4 Key policy issues in EU corporate governance

We now go on to illustrate a suggested approach for the EU to a number of key aspects of corporate governance, highlighting our agreements and disagreements with the Winter approach in the light of the discussion above.

In the case of *disclosure* related to corporate governance, the Winter Group proposes EU wide disclosure requirements for listed companies (although detailed rules would be set in Member States) referring to information about key elements of corporate governance rules in an annual statement, remuneration of directors, the costs of compensation schemes, the independence of directors and their qualifications, and group structures. We suggest that disclosure is a case where self-regulation by individual firms has proven insufficient, and we agree that although broad lines could be set by directive, the details should be left to national rules, operating through statute or voluntary agreement. We consider that focus on disclosure of corporate governance structures, including shareholders and their links to the company, is welcome and suggest rules could also extend to “open companies”. Valuation of share options and their incorporation in profit and loss should be a priority for the International Accounting Standards (IAS). We note that disclosure can easily be undertaken with an intention to mislead, suggesting that a template or model is needed to help cross-country comparability.

In terms of *voting* the Winter Group proposes EU wide rules with respect to information about voting, shareholder meetings, and cross border voting and access to shareholder meetings. Minority shareholders would have a right to request special investigation. Voting is again a case where self-regulation alone has proven insufficient; EU wide rules for cross border voting and access to shareholder meetings are clearly “mobility enhancing” and we supported it. They tie in strongly with the growth of cross border investment following EMU. Equally, the suggested special investigation right even for open and closed firms should be commended; it would be a radical change in some EU countries.

The Winter Group proposes the adoption of an EU recommendation strengthening the role of *independent directors* in audit, nomination, and remuneration committees as well as on the Board. Criteria are laid down for the independence of directors. We are in broad agreement with the focus on independent directors and their responsibilities, as well as the proposed locus of action. On the other hand, stringent rules for board members qualifications and responsibilities may discourage qualified individuals from board membership and could also cause difficulties in countries where creditor and labour representatives are normally members of the board. We would suggest that a definition of an independent director can be made relatively simple by a negative test which seeks to exclude conflicts of interest in dealings with the executive directors and majority shareholders (if they exist). Furthermore, we go beyond the Winter Group and recommend a minimum standard for independent board representation, such as 30%. This level is set below 50% for the case where there are blockholdings but could justifiably be much higher when there are dispersed shareholdings.

The Winter Group proposes EU support for national rules with respect to responsibilities of *institutional investors* to disclose investment policy and the exercise of voting rights, with voting strategies published and individual votes disclosed to beneficiaries of the institutional investor on request. Voting by institutional investors is again a case where self-regulation alone has proven insufficient in the light of their passivity in the face of management failure and lack of information to beneficiaries, and we agree with EU guidance rather than a recommendation or a directive in the light of different national traditions. We suggest to cover all institutions such as pension funds, life insurance companies and mutual funds, which hold assets backed directly by liabilities representing the savings of their beneficiaries. With respect to such institutional investors we would go further than the Winter Group and recommend that institutions be obliged to publish ex post a list of their votes in company meetings for their beneficiaries to examine. To be effective, this will of course require suitable action on voting as outlined above. It will shame those passively voting for management, and allow investigation of conflicts of interest. On the other hand we agree that compulsory voting is undesirable as it may induce funds to take positions in areas where they do not have expertise. Furthermore, although it seems unobjectionable to require EU institutional investors also to reveal their investment policies, this may best be covered by other forms of regulation such as the UCITS Directives.

The Winter Group suggests EU wide rules for *responsibility of board members for financial statements*. This issue is a case where self regulation alone has proven insufficient but we question whether an EU Directive is needed since collective responsibility is already enshrined in national legislation. We are in agreement with collective board responsibility for statements, as is current EU practice, rather than individual responsibility as suggested in the US.

5 Conclusion

The EU needs a system of corporate governance that sets standards to maintain confidence in the system, but which nonetheless respects national traditions, while permitting them to evolve under the influence of market forces. Doing business in another EU country, as well as investing in its firms, should not be a complex task. A certain set of minimum standards or “benchmarks” are required rather than a specific corporate governance system. This is applicable not only to the current EU countries but even more to the Accession Countries, whose corporate governance systems are still relatively immature. We contend that the types of suggestion made in this paper, inspired by the work of the Winter Group, should fulfill these criteria.