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GREEN PAPER

The EU corporate governance framework

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(Text with EEA relevance)

The Commission recently reiterated its commitment to a strong and successful single market which refocuses on citizens and regains their trust. As its Communication *Towards a Single Market Act* stated, ‘It is of paramount importance that European businesses demonstrate the utmost responsibility not only towards their employees and shareholders but also towards society at large’[1]. Corporate governance and corporate social responsibility are key elements in building people’s trust in the single market. They also contribute to the competitiveness of European business, because well run, sustainable companies are best placed to contribute to the ambitious growth targets set by ‘Agenda 2020’[2]. In the field of corporate social responsibility the Commission has already issued a public consultation on non-financial disclosure by companies[3] and will put forward a new framework initiative later this year to tackle issues related to the societal challenges that enterprises are facing.

The G20 Finance Ministers and Central Bank Governors Communiqué of 5 September 2009 emphasised that actions should be taken to ensure sustainable growth and build a stronger international financial system. Corporate governance is one means to curb harmful short-termism and excessive risk-taking[4]. The purpose of this Green Paper is to assess the effectiveness of the current corporate governance framework for European companies in the light of the above.

Corporate governance is traditionally defined as the system by which companies are directed and controlled[5] and as a set of relationships between a company’s management, its board, its shareholders and its other stakeholders[6]. The corporate governance framework for listed companies in the European Union is a combination of legislation and ‘soft law’, including recommendations[7] and corporate governance codes. While corporate governance codes are adopted at national level, Directive 2006/46/EC promotes their application by requiring that listed companies refer in their corporate governance statement to a code and that they report on their application of that code on a ‘comply or explain’[8] basis.

1 Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions *Towards a Single Market Act – for a highly competitive social market economy* - COM(2010) 608 final/2, p. 27.

2 See the Conclusions of the European Council of 17 June 2010, accessible at http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/115346.pdf.

3 The consultation on ‘disclosure of non-financial information by companies’ closed in January 2011; see http://ec.europa.eu/internal_market/consultations/2010/non-financial_reporting_en.htm.

4 See also, e.g., OECD, Corporate Governance and the Financial Crisis - Conclusions and emerging good practices to enhance implementation of the Principles, February 2010.

5 Report of the Committee on the Financial Aspects of Corporate Governance (The Cadbury Report), 1992, p. 15, accessible at http://www.ecgi.org/codes/documents/cadbury.pdf.

6 OECD Principles of Corporate Governance, 2004, p. 11, accessible at http://www.oecd.org/dataoecd/32/18/31557724.pdf.

7 For a list of EU measures in the field of corporate governance, see Annex 2.

8 This approach means that a company choosing to depart from a corporate governance code has to explain which parts of the corporate governance code it has departed from and the reasons for doing so.

To identify the issues most relevant to good corporate governance in the EU and to prepare this Green Paper, the Commission conducted interviews with a sample of listed companies from different Member States and different economic sectors, with different levels of capitalisation and different shareholding structures. It also held meetings with corporate governance experts and with representatives of the investor community and of civil society. Some relevant issues had already emerged in the context of the Green Paper on Corporate Governance in Financial Institutions and remuneration policies[9] adopted in June 2010. For example, shareholder engagement matters not just to financial institutions, but to companies generally[10]. However, financial institutions are a special case, because of the particular challenges faced in ensuring effective risk management and the systemic risks they may pose to the financial system. So the solutions envisaged in the June 2010 Green Paper may not be relevant to EU companies in general. Accordingly, this Green Paper addresses the following three subjects which are at the heart of good corporate governance:

- The board of directors – high performing, effective boards are needed to challenge executive management. This means that boards need non-executive members with diverse views, skills and appropriate professional experience. Such members must also be willing to invest sufficient time in the work of the board. The role of chairman of the board is particularly important, as are the board's responsibilities for risk management.

- Shareholders – the corporate governance framework is built on the assumption that shareholders engage with companies and hold the management to account for its performance. However, there is evidence that the majority of shareholders are passive and are often only focused on short-term profits. It therefore seems useful to consider whether more shareholders can be encouraged to take an interest in sustainable returns and longer-term performance, and how to encourage them to be more active on corporate governance issues. Moreover, in different shareholding structures there are other issues, such as minority protection.

- How to apply the 'comply or explain' approach which underpins the EU corporate governance framework. A recent study[11] showed that the informative quality of explanations published by companies departing from the corporate governance code's recommendation is - in the majority of the cases - not satisfactory and that in many Member States there is insufficient monitoring of the application of the codes. It is therefore appropriate to consider how to improve this situation.

Two preliminary questions also deserve consideration.

Firstly, European rules on corporate governance apply to 'listed' companies (i.e. companies that issue shares admitted to trading on a regulated market). They generally do not distinguish according to company size[12] or type. Some Member States, however, have specific corporate

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9 COM(2010) 284, see also Feedback Statement — Summary of responses to the Commission Green Paper on Corporate Governance in Financial Institutions, accessible at http://ec.europa.eu/internal_market/consultations/docs/2010/governance/feedback_statement_en.pdf.

10 See the abovementioned Green Paper, Sections 3.5 and 5.5.

11 Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, accessible on http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923_en.pdf.

12 But there are exceptions, for instance, Article 41(1), second subparagraph of the Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing

governance codes tailored to small and medium-sized listed companies[13], e.g. where the controlling shareholder may also be the manager. Those codes include recommendations that reflect company size and structure, which are therefore less complex for small businesses to implement. In other Member States, codes designed for all listed companies contain certain provisions tailored to smaller companies[14]. So the question is whether the EU should have a differentiated approach and how best to take account of the potential difficulty of applying some corporate governance practices across the range of types and sizes of companies[15].

Secondly, good corporate governance may also matter to shareholders in unlisted companies. While certain corporate governance issues are already addressed by company law provisions on private companies, many areas are not covered. Corporate governance guidelines for unlisted companies may need to be encouraged: proper and efficient governance is valuable also for unlisted companies, especially taking into account the economic importance of certain very large unlisted companies. Moreover, putting excessive burden on listed companies could make listing less attractive. However, principles designed for listed companies cannot be simply transposed to unlisted companies, as the challenges they face are very different. Some voluntary codes have already been drafted and initiatives taken by professional bodies at European[16] or national level[17]. So the question is whether any EU action is needed on corporate governance in unlisted companies.

Questions:

(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.

(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?

Council Directive 84/253/EEC (OJ L 157, 9.6.2006, p. 87) allows Member States to permit SMEs that are listed companies not to set up a separate audit committee.

13 See, for example, *Code de gouvernement d'entreprise pour les valeurs moyennes et petites*, December 2009, Middlenext, accessible at http://www.middlenext.com/.

14 See for example the *UK Corporate Governance Code,* accessible at http://www.frc.org.uk/corporate/ukcgcode.cfm.

15 The logic of burden reduction for small and medium companies is also present in the ongoing review of the accounting directives (Council Directives 78/660/EEC and 83/349/EEC), although it will mainly target non-listed companies and in the Green on the Audit policy published in 2010 - COM(2010) 561 -, available at http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf.

16 *Corporate Governance Guidance and Principles for Unlisted Companies in Europe*, European Confederation of Directors' Associations (EcoDa), accessible at http://www.ecoda.org/docs/ECODA_WEB.pdf.

17 See for instance in Belgium the *Buysse Code — Corporate governance recommendations for non-listed enterprises* (http://www.codebuysse.be/downloads/CodeBuysse_EN.pdf); in Finland the Central Chambers of Commerce initiative *Improving corporate governance of unlisted companies* (http://www.keskuskauppakamari.fi/content/download/19529/421972); in the UK, *Corporate Governance Guidance and Principles for Unlisted Companies in the UK,* Institute of Directors (http://www.iod.com/MainWebsite/Resources/Document/corp_gov_guidance_and_principles_for_unlisted_companies_in_the_uk_final_1011.pdf) .

1. BOARDS OF DIRECTORS

The term 'board of directors' in this Green Paper essentially refers to the supervisory role of directors. In a dual structure, this role generally falls to the supervisory board[18]. The term 'non-executive director' includes the members of the supervisory board in the dual system.

Boards of directors have a vital part to play in the development of responsible companies. And in many respects, the role played by the chairperson seems to have a considerable impact on the board's functioning and success. In view of this impact, it could be useful to define the position and responsibilities of the chairperson of the board more clearly.

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?

Other topics that merit closer examination, with a view to enabling boards of directors to challenge management decisions effectively, are considered below.

1.1. Board composition

The composition of the board has to suit the company's business. Non-executive board members should be selected on the basis of a broad set of criteria, i.e. merit, professional qualifications, experience, the personal qualities of the candidate, independence and diversity[19].

Diversity in the members' profiles and backgrounds gives the board a range of values, views and sets of competencies[20]. It can lead to a wider pool of resources and expertise. 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 but getting to those decisions may take more time. Therefore, the commitment and support of the chairperson is indispensable.

1.1.1. Professional diversity

Diversified expertise is considered the key to efficient board work. A variety of professional backgrounds is needed to ensure that the board as a whole understands, for example, the complexities of global markets, the company's financial objectives and the impact of the business on different stakeholders including employees. Companies interviewed by the Commission acknowledged the importance of identifying complementary profiles in selecting board members. However, this is not yet general practice. For example, 48% of European

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18 This Green Paper has no bearing on the roles assigned to different company bodies and board-level employee participation under national law.

19 It is worth noting that some Member States provide for regimes of employee participation in the boards

20 'Enhancing stakeholder diversity in the Board room', 'The Erfurt meetings' series, No 1, March 2008, European Citizens' Seminars e.V. (Erfurt, Germany) publishers.

boards have no director with a sales or marketing profile and 37% of audit committees do not include a chief financial officer (CFO) or former CFO[21].

Accurate assessment of skills and expertise is the single most important factor in selecting new non-executive board members. Therefore, recruitment policies which identify the precise skills needed by the board could help increase its ability to monitor the company effectively.

1.1.2. International diversity

In a sample of large European listed companies, an average of 29% of board members were non-nationals[22]. There were, however, great disparities among European countries. While the Netherlands leads the way with 54%, only 8% of board members in Germany were non-nationals. Even today, one in four large European listed companies has no foreign directors on its board.

Some companies highlighted the importance of foreign board members for international companies while others underlined the difficulties deriving from different cultural backgrounds and languages. In companies with foreign board members there is a match between their regional presence and their international board members. Knowledge of regional markets is often mentioned as a key factor in choosing foreign candidates for board membership.

1.1.3. Gender diversity

The issue of gender diversity in economic decision-making is being addressed in a comprehensive manner by the Commission in its "Strategy for equality between women and men 2010-2015" of September 2010[23] and in the follow-up given to this strategy by the Commission[24]. According to the Commission's findings, the proportion of women on the (supervisory) boards of listed companies in the EU is currently on average 12%[25]. There is evidence that the increase in the number of women university graduates does not bring about significant change in this respect[26]. Consequently, a number of Member States have taken steps to ensure gender balance on boards, or plan to do so[27]. Moreover, some companies interviewed mentioned that such requirements had helped to professionalise the selection procedure.

Gender diversity can contribute to tackling group-think. There is also evidence that women have different leadership styles[28], attend more board meetings[29] and have a positive impact on

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21 Heidrick & Struggles, *Corporate Governance Report 2009 — Boards in turbulent times*, using a selection of 371 top companies in 13 countries based on the reference stock exchange.

22 See Heidrick & Struggles.

23 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "Strategy for equality between women and men 2010-2015", COM(2010) 491 final.

24 See details in the Commission Staff Working Paper "The Gender Balance in Business Leadership", SEC(2011) 246 final.

25 European Commission, Database on women and men in decision-making http://ec.europa.eu/social/main.jsp?catId=764&langId=en.

26 *Women matter*, McKinsey & Company 2007, 2010.

27 See the above mentioned Commission Staff Working Paper.

28 *Women matter*, McKinsey & Company 2008.

29 Adams and Ferreira ‘Women in the boardroom and their impact on governance and performance’, in *Journal of Financial Economics* 94 (2009).

the collective intelligence of a group[30]. Studies suggest there is a positive correlation between the percentage of women in boards and corporate performance[31], though for certain the overall impact of women on firm performance is more nuanced[32]. Although these studies do not prove any causality, the correlation highlights the business case for gender balance in management and corporate decision-making. Nonetheless, promoting women to boards has as one indisputably positive effect: it contributes to increasing the pool of talent available for a company's highest management and oversight functions. This is why the Commission's "Strategy for equality between women and men" stresses that over the next five years, the Commission will "consider targeted initiatives to improve the gender balance in decision-making".

The introduction of measures such as quotas or targets to ensure gender balance in boards, however, is not sufficient if companies do not adopt diversity policies that contribute to work-life balance for women and men and encourage notably the mentoring, networking and adequate training for management positions that are essential for women wanting to follow a career path that leads to eligibility for board positions. While it should be for companies to 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. The Commission will consider these matters in the context of the follow-up to its "Strategy for equality between women and men 2010-2015" of September 2010 and to this Green Paper.

Questions:

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

1.2. Availability and time commitment

The role of non-executive directors has grown in complexity and importance. This is reflected in a number of national corporate governance codes and even in legislation. Member States have sought to establish the principle that non-executive directors should dedicate sufficient time to their duties. Some Member States have gone further and recommend or limit the number of board mandates a director may hold.

Limiting the number of mandates could be a simple solution to help ensure non-executive directors devote sufficient time to monitoring and supervising their particular companies. The

30 Woolley, Chabris, Pentland, Hashmi and Malone, 'Evidence for a Collective Intelligence Factor in the Performance of Human Groups', Sciencexpress, 30 September 2010.

31 *Women matter*, McKinsey & Company 2007; *Female Leadership and Firm Profitability*, Finnish Business and Policy Forum — EVA 2007; *The Bottom Line: Connecting Corporate Performance and Gender Diversity*, Catalyst 2004.

32 See Adams and Ferreira.

limits would have to cater for the individual situation of non-executive directors and of the company in question. They should take into account whether the mandates are held in non-group or non-controlled undertakings[33], whether the person in question also holds executive positions, whether it is an ordinary non-executive mandate or a chairmanship, and whether additional positions are held in supervisory bodies of companies with requirements similar to those of listed companies.

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?

1.3. Board evaluation

The Commission's 2005 Recommendation on the role of non-executive or supervisory directors of listed companies[34] stated that the board should evaluate its performance annually. This includes assessing its membership, organisation and operation as a group, the competence and effectiveness of each board member and of the board committees, and how well the board has performed against any performance objectives set.

Regular use of an external facilitator (e.g. every third year) could improve board evaluations by bringing an objective perspective and sharing best practices from other companies[35]. But there still seems to be only a limited number of service providers in some domestic markets. Greater demand, however, is likely to engender a better offer.

Evidence gathered by the Commission suggests that it is particularly at a time of crisis, or of a breakdown in communication between board members, that an external reviewer really adds value to the evaluation. The chairman's attitude to evaluation seems to be key to its success.

In addition to the items mentioned in the Commission Recommendation, the review should also cover the quality and timeliness of information received by the board, the management's response to requests for clarification and the role of the chairman[36]. To encourage openness, a degree of confidentiality should be maintained. So any evaluation statement to be 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 could this be done?

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33 'Controlled undertaking', as defined in Article 2(1)(f) of Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC. See also the parent-subsidiary relationship as explained in Article 1 of Directive 83/349/EEC on consolidated accounts.

34 Commission Recommendation 2005/162/EC of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.

35 OECD, *Corporate governance and the financial crisis: Conclusions and emerging good practices to enhance implementation of the Principles*, 24 February 2010, p. 20.

36 See Higgs, D. *Review of the role and effectiveness of non-executive directors*, January 2003.

1.4. Directors' remuneration

As a concept, corporate governance essentially 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. Poor remuneration policies and/or incentive structures may lead to unjustified transfers of value from companies and their shareholders and other stakeholders to executives. Moreover, a focus on short-term performance criteria may have a negative influence on long-term sustainability of the company.

The Commission has addressed problems related to directors' remuneration in three Recommendations[37]. The main recommendations are disclosure of remuneration policy and the individual remuneration of executive and non-executive directors, the shareholders´ vote on the remuneration statement, an independent functioning remuneration committee and appropriate incentives which foster performance and long-term value creation by listed companies. Commission reports[38] show that a number of Member States have not adequately addressed these issues. On the other hand, there appears to be a growing tendency among Member States to legislate on disclosure and the shareholders´ vote. In 2009, the European Corporate Governance Forum recommended that disclosure of remuneration policy and individual remuneration be made mandatory for all listed companies[39]. It also recommended a binding or advisory shareholder vote on remuneration policy and greater independence for non-executive directors involved in determining remuneration policy. The Commission also consulted on this issue in the 2010 Green Paper on Corporate Governance in Financial Institutions[40]. The purpose of the consultation in this Green Paper is to receive feedback as regards the more detailed questions below.

Questions:

(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?

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

1.5. Risk management

All companies, whatever their specific fields of operations, face a wide variety of external or internal risks. According to their specificities (field of activity, size, international exposure,

[37] Commission Recommendations 2004/913/EC, 2005/162/EC and 2009/385/EC.

[38] Commission reports SEC(2007) 1022 and (2010) 285.

[39] Statement by the European Corporate Governance Forum of 23 March 2009.

[40] See question 7.1. Respondents to the consultation generally expressed the view that incentives for directors must be properly structured in order to encourage long term and sustainable performance of companies. However, the majority was opposed to legislative measures as regards the structure of remuneration in listed companies. Nevertheless, certain respondents mentioned that they would welcome more transparency of remuneration policies of directors of listed companies and a shareholder vote.

complexity) they should develop an adequate risk culture and arrangements to manage them effectively. Some companies may face risks that significantly affect society as a whole: risks related to climate change[41], to the environment (e.g. the numerous dramatic oil spills witnessed in recent decades), health, safety, human rights, etc. Others operate critical infrastructure, the disruption or destruction of which could have major cross-border impacts[42]. However, activities that might potentially generate such risks are subject to specific sectoral legislation and to monitoring by competent authorities. Thus, taking into account the diversity of situations, it does not seem possible to propose a 'one size fits all' risk management model for all types of companies. It is, however, 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 generally recognised[43] that the board of directors bears primary responsibility for defining the risk profile of a given organisation according to the strategy followed and monitoring it adequately to ensure it works effectively.

Some aspects may differ due to the variety of legal frameworks in place, e.g. the dual or unitary structure of board of directors. In each case, 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. The job descriptions must be known internally and externally.

Questions:

(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?

(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?

2. SHAREHOLDERS

Shareholders' role in corporate governance was addressed in the Green Paper on corporate governance in financial institutions, published in June 2010.

The June 2010 Green Paper found that a lack of appropriate shareholder interest in holding financial institutions' management accountable contributed to poor management accountability and may have facilitated excessive risk taking in financial institutions. It found that, in many cases, shareholders deemed the expected profits from taking these risks worthwhile and so implicitly supported excessive risk taking, especially though high leverage. The reason is that shareholders would fully benefit from the upside of such a strategy, while they participate in losses only until the value of shareholder equity reaches zero, after which

41 E.g. resilience of the company's investments to climate change, financial or other implications from regulation on greenhouse gas emissions.

42 EU 'critical infrastructure protection' webpage: http://europa.eu/legislation_summaries/justice_freedom_security/fight_against_terrorism/jl0013_en.htm

43 From Commission interviews.

further losses would be borne by the creditors (known as the "limited liability" of shareholders).

The behaviour of shareholders in financial institutions, in relation to excessive risk taking, may be a special case because their operations are complex and difficult to understand. Nonetheless, the evidence gathered during the preparation of this Green Paper suggests that the findings of the 2010 Green Paper regarding the lack of shareholder engagement and the reasons for this are, to a large extent, also relevant to shareholder behaviour in listed companies with dispersed ownership. In companies with a dominant or controlling shareholder, it seems that the major challenge is to ensure that the (economic) interests of minority shareholders are adequately protected. In addition, minority shareholders who are willing to engage with companies may also be confronted with the difficulties set out below.

2.1. Lack of appropriate shareholder engagement

Shareholder engagement is generally understood as actively monitoring companies, engaging in a dialogue with the company's board, and using shareholder rights, including voting and cooperation with other shareholders, if need be to improve the governance of the investee company in the interests of long-term value creation. Although engagement on the part of short-term investors may have a positive effect[44], it is generally understood as an activity which improves long-term returns to shareholders[45]. Therefore, the Commission believes that it is primarily long-term investors[46] who have an interest in engagement.

Some of the reasons for a lack of shareholder engagement were set out in the 2010 Green Paper and will not be repeated here. Some of these reasons, such as the cost of engagement, the difficulty of valuing the return on engagement and the uncertainty of the outcome of engagement, including free rider behaviour, seem to have an impact on most institutional investors[47]. In the 2010 Green Paper the Commission also asked whether institutional investors, including asset owners and managers, should be required to publish their voting policies and records. The vast majority of respondents supported such a rule. They thought public disclosure would improve investor awareness, optimise investment decisions by the ultimate investors, facilitate issuers' dialogue with investors and encourage shareholder engagement. One of the options currently considered by the Commission would therefore be a framework for transparency in voting policies and disclosure of general information about their implementation while respecting the equal treatment of shareholders.

2.2. Short-termism of capital markets

Major developments in capital markets in recent decades, including innovative products and technical change, mostly focused on the trading function of the capital markets and facilitated faster and more efficient trading. Innovations such as high-frequency and automated trading seem to have resulted in increased liquidity but also helped to shorten shareholding periods. Over the past two decades, investment horizons have shortened considerably. Turnover on the

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44 For instance, engagement by typical short-term-oriented institutional investors, such as 'activist' hedge funds, may be beneficial, because it can act as a catalyst for a change in governance and raise awareness among other shareholders.

45 See the UK Stewardship Code.

46 Investors with long-term obligations towards their beneficiaries, such as pension funds, life insurance companies, state pension reserve funds and sovereign wealth funds.

47 For the purposes of this Green Paper, 'institutional investor' is understood in a broad sense, i.e. as any institution which professionally invests (also) on behalf of clients and beneficiaries.

major equity exchanges is now running at 150% per year of aggregate market capitalisation, which implies average holding period is eight months.

At the same time, intermediation of investments has increased, amplifying the importance of the agency relationship between long-term investors and their asset managers. It has been argued that the agency relationship actually contributes to short-termism on the market, which may also cause mispricing, herd behaviour, increased volatility and lack of ownership of listed companies. This issue is explained in Section 2.3.

Some investors have also complained of a 'regulatory bias' towards short-termism, which hinders long-term investors, in particular, from adopting longer-term investment strategies. During the Commission's preliminary consultations with stakeholders it was said that solvency and pension fund accounting rules, which were intended to promote greater transparency and more effective market valuation, have had unintended consequences.

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.

2.3. The agency relationship between institutional investors and asset managers

The Commission recognises that not all investors need to engage with investee companies. Investors are free to choose a short-term-oriented investment model without engagement.

However, the agency relationship between institutional investors (asset owners) and their managers contributes to capital markets' increasing short-termism and to mispricing[48]. This issue is particularly relevant as regards the inactivity of long-term-oriented shareholders.

2.3.1. Short-termism and asset management contracts

It appears that the way asset managers' performance is evaluated and the incentive structure of fees and commissions encourage asset managers to seek short-term benefits. There is evidence (confirmed in the Commission's dialogue with institutional investors) that many asset managers are selected, evaluated and compensated based on short-term, relative performance. Performance evaluation on a relative basis, i.e. the extent to which they outperform or underperform a market index, can encourage herd behaviour and a short-term focus, particularly if short interval is used to measure performance. The Commission believes that short-term incentives in asset management contracts may contribute significantly to asset managers' short-termism, which probably has an impact on shareholder apathy.

Many respondents to the June 2010 Green paper[49] supported greater disclosure of the incentive structures for asset managers. The question is then whether additional measures to better align the interests of long-term institutional investors and asset managers are appropriate (for example developing a set of investment principles).

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48 Paul Woolley, 'Why are financial markets so inefficient and exploitative — and a suggested remedy', in *The Future of Finance: The LSE Report*, 2010.

49 Respondents in favour were mostly investors, asset managers, the (financial services) industry and business professionals.

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?

2.3.2. Lack of transparency about the performance of fiduciary duties

More transparency about the performance of fiduciary duties by asset managers, including their investment strategies, the cost of portfolio turnover, whether the level of portfolio turnover is consistent with the agreed strategy, the cost and benefits of engagement, etc., could shed more light on whether or not asset managers' activities are beneficial for long-term institutional investors and long-term value creation on their behalf.

Furthermore, 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[50].

More transparency on these issues would help institutional investors to better monitor their agents and thus have a greater influence on the investment process. As a consequence of such improved monitoring, long-term institutional investors might decide to renegotiate asset management contracts to introduce portfolio turnover caps and require their asset managers to be more active stewards of the investee companies[51].

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?

2.4. Other possible obstacles to engagement by institutional investors

2.4.1. Conflicts of interest

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. An example of this can be found in financial groups where the asset management branch may not want to be seen to actively exercise its shareholder rights in a company to which its parent company provides services or in which it has a shareholding.

Question:

50 See also paragraph 7.3.4 of the Public consultation on the Review of the Markets in Financial Instruments Directive (Mifid): http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf

51 On 31 January 2010, the ICGN Shareholder Responsibilities Committee has published a call for evidence with regard to model contract terms for agreements between asset owners and their fund managers: http://www.icgn.org/policy_committees/shareholder-responsibilities-committee/-/page/307/.

(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?

2.4.2. Obstacles to shareholder cooperation

Individual investors, in particular those with diversified portfolios, may not always engage successfully. Shareholder cooperation could help them to be more effective.

Many respondents to the 2010 Green Paper proposed that existing EU law on acting in concert, which may hinder effective shareholder cooperation, should be amended. The Commission recognises that clearer and more uniform rules on acting in concert would indeed be beneficial in this respect. Other ideas have been advanced to facilitate shareholder cooperation: some suggest setting up shareholder cooperation fora, while others propose an EU proxy solicitation system where listed companies would be required to set up a specific function on their website enabling shareholders to post information on particular agenda items and seek proxies from other shareholders.

Some investors have mentioned 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. However late transposition of the directive by many Member States means the real impact for the individual end investor is only now becoming apparent. Furthermore, there seems to be a problem in the actual transmission of relevant information between the issuer and the shareholder through the chain, particularly in cross-border situations. The Commission is aware of the difficulties and will look into this issue in relation to its work on harmonising securities law.

Question:

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

2.5. Proxy advisors

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. So they make frequent use of the services of proxy advisors, such as voting advice, proxy voting and corporate governance ratings. In consequence, proxy advisors' influence on voting is substantial. Moreover, it has been argued that institutional investors rely more heavily on voting advice for their investments in foreign companies than for investments in their home markets. As a consequence, the influence of proxy advisors would be greater in markets with a high percentage of international investors.

The influence of proxy advisors raises some concerns. During the preparation of this Green Paper, investors and investee companies shared their concerns that proxy advisors are not sufficiently transparent about the methods applied with regard to the preparation of the advice. More specifically, it is said that the analytical methodology fails to take into account firm-specific characteristics and/or characteristics of national legislation and best practice on corporate governance. Another concern is that proxy advisors are subject to conflicts of interest. When proxy advisors also act as corporate governance consultants to investee companies, this may give rise to conflicts of interest. Conflicts of interest also arise when a proxy advisor advises on shareholder resolutions, proposed by (one of) his clients. Finally, the lack of competition in the sector raises concerns, partly about the quality of the advice and whether it meets investors' needs.

Questions:

(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?
(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?

2.6. Shareholder identification

There have been demands recently for EU action to increase the level of investor transparency[52] towards issuers of shares[53]. Proponents argue that means of identifying their shareholders will enable issuers to engage in a dialogue with them, in particular in matters of corporate governance. This could also generally increase the involvement of shareholders in the companies they invest in[54]. About two thirds of Member States have already granted issuers the right to know their domestic shareholders[55]. In addition, the Transparency Directive[56] and related national implementation measures provide for a degree of transparency of holdings above a certain threshold[57].

Others disagree with the demand to create a European tool for shareholder identification. They consider that modern means of communication have made it very easy to inform shareholders and potential investors about corporate governance issues and to get their views. Better knowledge of shareholders could also lead to management entrenchment, i.e. help management to better defend themselves against any actions by shareholders to challenge their conduct of business. In certain Member States there may also be privacy considerations related to data protection rules forbidding intermediaries to pass on information on shareholders to issuers.

Question:

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[52] For more detailed information, see the Commission staff working document 'The review of the operation of Directive 2004/109/EC: emerging issues' accompanying document to the Report from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions Operation of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market - SEC(2009) 611, pp. 88-94.

[53] This question was also raised in the Green Paper *Corporate governance in financial institutions and remuneration policies* - COM(2010) 284 - which was, however, limited to financial institutions.

[54] The Commission already looked at the risk of abuse connected to 'empty voting' in its consultation on the Transparency Directive. That consultation suggested that the problem was one of 'record date capture'.

[55] For more details, see Market analysis of shareholder transparency regimes in Europe, ECB T2S Taskforce on Shareholder Transparency, 9 December 2010: http://www.ecb.int/paym/t2s/progress/pdf/subtrans/mtg7/2010-t2s-tst-questionnaire-response-analysis.pdf?d6cc9adf38f63d24897c94e379213b81

[56] Directive 2004/109/EC.

[57] In the revision of the Transparency Directive foreseen for 2011, the Commission is also envisaging introducing a disclosure requirement for the long economic positions having similar economic effect to holding of shares.

(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).

2.7. Minority shareholder protection

Minority shareholder protection is relevant in relation to the role of shareholders in corporate governance for a number of reasons.

Minority shareholder engagement is difficult in companies with controlling shareholders, which remain the predominant governance model in European companies. This raises the question whether the 'comply or explain' system is viable in such companies, particularly where adequate protection of minority shareholders is not guaranteed.

Secondly, the question arises whether the existing EU rules are sufficient to protect minority shareholders' interests against potential abuse by a controlling shareholder (and/or the management).

2.7.1. Scope for engagement and the functioning of 'comply or explain' where there is a controlling or dominant shareholder

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

2.7.2. Protection against potential abuse

Controlling shareholders and/or boards can extract benefits from a company to the detriment of minority shareholders' interests in many ways. The main way is through 'related party' transactions.

Current EU rules already cover some aspects of related party transactions, basically accounting and disclosure. Companies are required to include in their annual accounts a note on transactions entered into with related parties, stating the amount and the nature of the transaction and other necessary information[58].

However, some investors with whom discussions were held during the preparation of this Green Paper argue that the rules are insufficient. They believe that disclosure of related party transactions is not enough in all situations and is not always timely.

[58] See Article 43(1)(7b) of the Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies and Article 34(7b) of the Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts.

It has been suggested[59] 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. Significant related party transactions would need approval by the general meeting. 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.

Question:

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

2.8. Employee share ownership

Employees' interest in the long-term sustainability of the company for which they work is an element that a corporate governance framework should take into account. Employees' involvement in the affairs of a company may take the form of information, consultation and participation in the board. But it can also relate to forms of financial involvement, particularly to employees becoming shareholders. Employee share ownership has a long tradition in some European countries[60]. Such schemes are mainly considered as means to increase the commitment and motivation of workers, raise productivity and reduce social tension. But employee share ownership also involves risks from lack of diversification: if the company fails, employee shareholders may lose both their job and their savings. However, employees as investors could play an important role to increase the proportion of long-term-oriented shareholders.

Question:

(23)	Are there measures to be taken, and is so, which ones, to promote at EU level employee share ownership?

3. THE 'COMPLY OR EXPLAIN' FRAMEWORK – MONITORING AND IMPLEMENTING CORPORATE GOVERNANCE CODES

Surveys among companies and investors show that most of them consider 'comply or explain' approach as an appropriate tool in corporate governance. Under the 'comply or explain' approach, a company which chooses to depart from a corporate governance code recommendation must give detailed, specific and concrete reasons for the departure. Its main advantage is its flexibility; it allows companies to adapt their corporate governance practices to their specific situation (taking into consideration their size, shareholding structure, and sectoral specificities). It is also thought to make companies more responsible by encouraging them to consider whether their corporate governance practices are appropriate and by giving them a target to meet. The 'comply or explain' approach is therefore widely supported by

59 See the Statement on minority shareholders' rights by the European Corporate Governance Forum.

60 Communication on the framework for promoting employee financial participation - COM(2002) 364 -, The PEPPER IV Report: Benchmarking of Employee Participation in Profits and Enterprise Results in the Member and Candidate Countries of the European Union, 2008.

regulators, companies and investors, as shown by a study on monitoring and enforcement systems for Member States' corporate governance codes published in autumn 2009[61].

However, the general introduction of the 'comply or explain' approach in the EU has had its difficulties. The study referred to above revealed important shortcomings in applying 'comply or explain' principle that reduce the efficiency of the EU's corporate governance framework and limit the system's usefulness. So 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. However, 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.

3.1. Improving the quality of the explanations given in corporate governance statements

According to the study cited above, the overall quality of companies' corporate governance statements when departing from a corporate governance code recommendation is unsatisfactory. Its explanations are used by investors to make their choices and assess the value of the company. The study showed, however, that in over 60% of cases where companies chose not to apply recommendations, they did not provide sufficient explanation. They either simply stated that they had departed from a recommendation without any further explanation, or provided only a general or limited explanation.

In many Member States a slow but gradual improvement in this field can already be observed. Companies are learning, and better explanations are being provided thanks to the educational activities of public or private bodies (financial market authorities, stock exchanges, chambers of commerce, etc). However, further improvement could be achieved by introducing more detailed requirements for the information to be published by companies departing from the recommendations. The requirements should be clear and precise – many of the present difficulties are due to misunderstanding of the nature of the explanations required.

A good example of a precise requirement for companies is the Swedish corporate governance code, which provides that 'in its corporate governance report, the company is to state clearly which Code rules it has not complied with, explain the reasons for each case of non-compliance and describe the solution it has adopted instead'[62]. It would indeed seem 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.

3.2. Better monitoring of corporate governance

The 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, depending on the culture and traditions in their Member State, often take little action. Financial market authorities or stock exchanges and other monitoring bodies work within different legislative frameworks and have developed different practices. In most cases, they only have a formal role of verifying whether the corporate governance statement

[61] Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, available at http://ec.europa.eu/internal_market/company/ecgforum/studies_en.htm.

[62] See http://www.corporategovernanceboard.se/the-code/current-code, point 10.2.

has been published. Few Member States have public or specialised authorities check the completeness of the information provided (in particular, the explanations).

'Comply or explain' could work much better if monitoring bodies such as securities regulators, stock exchanges or other authorities[63] were authorised to check whether the available information (in particular, the explanations) is sufficiently informative and comprehensive. The authorities should not, however, interfere with the content of the information disclosed or make business judgements on the solution chosen by the company. The authorities could make the monitoring results publicly available in order to highlight best practice and to push companies towards more complete transparency. Use of formal sanctions in the most serious cases of non-compliance could also be envisaged[64].

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 and thus make it subject to the powers of competent national authorities laid down in Article 24(4) of the Directive.

As regards the different practices developed by monitoring bodies, there is great potential for improving and extending the current exchange of best practice.

Questions:

(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?

(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?

4. NEXT STEPS

Member States, the European Parliament, the European Economic and Social Committee and other interested parties are invited to submit their views on the suggestions set out in this Green Paper. Contributions should be sent to the following address to reach the Commission by 22 July 2011 at the latest: markt-complaw@ec.europa.eu. In the follow-up to this Green Paper and 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.

Contributions will be published on the internet. It is important to read the specific privacy statement attached to this Green Paper for information on how your personal data and contribution will be dealt with.

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63 The role of auditors is not discussed here, as a consultation on the role of statutory audit has been launched through a separate green paper available at http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf.

64 As, for example, is done in Spain — see the Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, p. 63.

Annex 1: List of questions

General questions

(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.

(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?

Boards of directors

(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?

(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?

(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?

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

(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?

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

(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?

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

(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?

(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?

Shareholders

(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.

(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?

(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?

(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?

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

(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?

(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?

(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).

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

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

(23) Are there measures to be taken, and is so, which ones, to promote at EU level employee share ownership?

Monitoring and implementation of Corporate Governance Codes

(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?

(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?

Annex 2: List of EU measures in the field of corporate governance

- Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (OJ L 224, 16.8.2006, p. 1–7).

- Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (OJ L 390, 31.12.2004, p. 38–57).

- Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies (OJ L 184, 14.7.2007, p. 17–24).

- Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids (OJ L 142, 30.4.2004, p. 12–23).

- Commission Recommendation 2005/162/EC of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (OJ L 52, 25.2.2005, p. 51–63).

- Commission Recommendation 2004/913/EC of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (OJ L 385, 29.12.2004, p. 55–59).

- Commission Recommendation 2009/385/EC of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (OJ L 120, 15.5.2009, p. 28–31).