EU Green Paper

CORPORATE GOVERNANCE

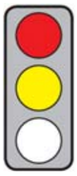
Status: 6 June 2011

Centrum für Europäische Politik

MAIN ISSUES

Objective of the Green Paper: The Commission wishes to revise corporate governance rules.

Parties Affected: Companies, supervisory boards and shareholders.



Pros: More transparency of the remuneration structure of listed companies and of asset managers' and advisors' activities makes it easier for shareholders to exercise their voting rights.

Cons: (1) The Commission's assumption that risky thinking or short-termism is generally negative ignores the operating conditions of the market economy.

(2) Quotas for non-nationals or women intervene in the property rights of shareholders and infringe the principle of subsidiarity.

(3) Excluding majority shareholders from decisions on significant transactions that they participate in is an intervention in the basic right of property (Art. 17 Charter of Fundamental Rights).

(4) The supervision of governance statements through authorities undermines the "comply or explain" principle, which is based on the freedom of decision.

CONTENT

Title

Green Paper COM(2011) 164 of 5 April 2011: European **Corporate Governance Framework**

Brief Summary

► **General**

– "Corporate Governance" means the system by which companies are directed and controlled, the relationships between a company's management, its board and its shareholders and between a company and the public. Management bodies are either the managing and supervisory boards or the board of directors.

– According to the Commission, the key issues of corporate governance focus on separating ownership and control.

– According to the Commission, short-termism and excessive risk-taking endanger sustainable economic growth and the stability of financial markets. It wishes to curb this threat through stricter corporate governance rules. Therefore, in its Green Paper it discusses different approaches and develops a questionnaire (s. Annex) addressed to the public asking whether or not and how the corporate governance framework could be improved.

– At EU level there is no consistent corporate governance code. With regard to listed companies, there are individual provisions in various Directives and Recommendations (s. Annex).

– The Commission basically asks if and how
  - small and medium-sized enterprises (SMEs) should be differentiated at EU level and
  - corporate governance rules should also be introduced for non-listed companies at EU level.

– The Commission addresses four subjects:
  - corporate governance rules for supervisory boards;
  - remuneration for members of managing and supervisory boards;
  - participation of shareholders in corporate governance and
  - monitoring and implementation of corporate governance codes.

► **Corporate governance rules for supervisory boards**

– **Duties and competences**

The Commission suggests clearly defining the duties and competences of the chairman of the supervisory board and differentiating it from the chairman of the managing board.

– **Diversity policies**
  - Companies should develop comprehensive "diversity policies" in order to increase the share of women and non-nationals in supervisory boards. In the supervisory board of the EU's largest listed companies only 12% of the members are women and 29% are non-nationals.
  - Diversity policies should include quotas or aims for women and non-nationals.
  - Moreover, diversity policies should:
    - provide training possibilities for women preparing them for management positions,
    - "encourage notably" the networking of women and
    - "mentoring" of their professional development.

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- The Commission leaves it open whether or not diversity policies should be legally binding. However, it wishes at least to oblige supervisory boards to discuss the introduction of diversity policies and to publish their decisions in favour of or against such policies.

– **Mandate restriction**
The number of supervisory board mandates a director may hold is to be limited in consideration of the remaining professional activities the person concerned is involved in and the corporate structure.

– **Supervisory board evaluation**
- The Commission promotes an evaluation of supervisory boards through external "reviewers".
- The evaluation should address the following:
  - composition and organisation of supervisory boards;
  - competence and performance of individual members and committees;
  - quality and availability of corporate information and
  - cooperation with the managing board.

– **Risk management**
The supervisory board should define the risk policy of a company by setting a framework "from the top" (p. 10) and by monitoring and answering for its compliance.

► **Remuneration of managing and supervisory board members**

– Member States "have not adequately addressed" the issues mentioned in the Recommendation on the remuneration of directors [C(2009) 3177; see CEP Policy Brief] (p. 9). In particular, the Commission calls for, as does the Recommendation, the following obligations for listed companies:
- disclosure of the remuneration policy and of the remuneration of the managing and supervisory boards;
- establishment of an independent remuneration committee;
- voting by the shareholders on the remuneration policy and
- remuneration agreements creating incentives for "performance" and "long-term value creation".

► **Shareholder engagement in Corporate Governance**

– **Shareholder engagement**
- Many shareholders support a high degree of entrepreneurial risk-taking as they always benefit from their profits, whereas they are only affected by losses if the "value of shareholder equity reaches zero" (p. 11).
- Shareholders should – within a dialogue with the supervisory board and through their voting rights – engage in long-term return targets.
- The Commission raises the question of which provisions might promote short-termism and how these provisions could be revised.
- The Commission criticizes the lack of transparency in the engagement of institutional investors. It wishes to establish a "framework for transparency" (p. 12) forcing institutional investors to publish their voting policies and records.

– **Role of asset managers**
- The Commission defines "asset managers" as persons and companies investing and managing assets of institutional investors.
- The Commission criticises that asset managers do not publish their voting policies regarding the shares they manage, in particular where business relations exist with the companies concerned.
- According to the Commission, the industry-standard remuneration and incentive structure for asset managers contributes to short-termism, "mispricing" and increased price fluctuations.
- For the Commission, short-termism of asset managers is in conflict with the interests of long-term oriented institutional investors. Therefore, it discusses whether or not and how a balance of interests could be reached, for instance, through developing a set of investment principles.
- Moreover, the Commission promotes more transparency regarding strategies, costs and returns following the engagement of asset managers. Thus it hopes to gain a better control of asset managers through long-term oriented institutional investors.

– **Proxy advisors for voting rights and corporate governance**
- The Commission appreciates that institutional investors with highly diversified portfolios delegate their voting rights to asset managers and make use of their corporate governance rating services. These services are provided by external proxy advisors.
- However, the Commission warns against conflicting interests if a proxy advisor:
  - advises on shareholder resolutions proposed by one of their clients, or
  - if a proxy advisor also acts as a corporate governance consultant to the company whose shares are held.
- The Commission calls for more transparency, notably through the disclosure of conflicting interests and conflict management policies. It raises the question of whether the simultaneous consultation of companies and their shareholders should be prohibited.
- The Commission further criticizes the lack of competition among "proxy advisors", though without offering any solutions.

– **Shareholder identification**
The Commission discusses whether a system should be introduced for issuers to automatically identify their shareholders. It hopes that in this way the dialogue between companies and shareholders could be improved.
– **Minority shareholder protection**
- The Commission wishes to better protect minority shareholders and proposes the following options:
  - some supervisory board seats could be reserved for minority shareholders;
  - assess the business relationships between the company to be monitored and persons or companies which are "affiliated" to supervisory board members through an independent expert and
  - "significant related party transactions" (p. 17) must be subject to a prior approval by the general meeting of shareholders, where required even the majority shareholders participating in these transactions should be precluded.
– **Employee share ownership**
The Commission assumes employee interest in the long-term sustainability of a company and looks for possibilities for promoting the share ownership of employees.

► **Monitoring and implementing corporate governance codes**
– The Commission affirms the "comply or complain" approach: the corporate governance code must be complied with; non-compliance must otherwise be explained in the form of so-called governance statements.
– The Commission deems more than 60% of the governance statements insufficient. Therefore it wishes to:
- define the corporate governance statement as an integral part of Article 2(1)(k) of the Transparency Directive (2004/109/EC) to make the subject to the powers of competent surveillance authorities;
- oblige companies to explain why they deviated from corporate governance codes and which solution they chose instead.

Statement on Subsidiarity by the Commission
The Commission does not address the issue of subsidiarity.

Policy Context
The Green Paper is a follow-up to the Internal Market Act [COM(2010) 608; s. CEP Policy Brief] in which the Commission called upon companies to assume more responsibility towards their shareholders and society as a whole. The women's quota has been under request by the EU Commission for quite some time. The latest step in that direction is the announcement of the Strategy for equality between women and men 2010-2015 [COM(2010) 491; s. CEP Policy Brief].

Options for Influencing the Political Process
Leading Directorate General:	DG Internal Market and Services
Consultation procedure:	Each citizen may comment on it. The procedure ceases on 22 July 2011.

ASSESSMENT
Economic Impact Assessment
Ordoliberal Assessment
EU-wide corporate governance rules are double-edged. On the one hand, they improve the cross-border mobility of capital, for if shareholders have no knowledge of diverging rules in other Member States, they are likely to limit their engagement to the home market they are familiar with. On the other hand, they do not reflect the individual historical, legal and socio-economic conditions as much as national corporate governance codes do, which are based on many years of practical experience.
The Commission sees the main reason for corporate governance rules in the separation of the management, its supervision and corporate property. In particular for owner-managed small and medium-sized non-listed enterprises the said separation is not the rule. To this end, there is no reason for extending the rules to these enterprises.
Basically, the Commission describes risky thinking and short-termism as being negative; this is too general a statement. **In market economies, the ability to take effective decisions at short notice and a positive approach towards risk-taking are of utmost importance** in order to be able to adjust quickly to market changes and to manage scarce resources towards areas with a high future potential. This leads inevitably to uncertainty.
"Diversity policies" to increase the share of women and non-nationals constitute an intrusion into shareholders' property rights, provided they are legally binding. Only they should be able to decide who should be in charge of monitoring their companies. From an ordoliberal standpoint, a quota system for female and foreign supervisory board members would be wrong, as each board seat should be held by the best

qualified applicant. A quota system would run counter to that, as it restricts the choice of applicants in an artificial manner.
A regulatory monitoring of governance statements undermines the "comply or explain" principle of corporate governance codes, **which is based on the freedom of decision**. For the monitoring will lead to regulatory criticism if a rule is not applied. Thus companies come under inappropriate pressure to explain things, which in facts means they are forced to fully apply the corporate governance codes and deviations are prevented.

Impact on Efficiency and Individual Freedom of Choice

Increased transparency requirements regarding the remuneration structure of listed companies and the activities of asset managers and advisors **make it easier for shareholders to exercise their shareholder rights**.
The more transparent remuneration policies are, the better shareholders can evaluate them and avoid the situation whereby remuneration models set incentives to excessive risk-taking. **However, this transparency should not be statutorily forced,** for companies compete with each other to acquire the capital of shareholders' investments. This competition ensures that listed companies cannot in the long run ignore the shareholders' interest in information regarding their remuneration policies.
More transparency with regard to the strategies, the costs and returns of the asset managers' engagement enable institutional investors to find the right asset manager. Moreover, by reducing information deficits, transaction costs for institutional investors are also reduced.
Indeed, the interests of asset managers and long-term oriented institutional investors might deviate from each other due to industry-standard incentive structures. This problem can be solved by transparent incentive structures. However, setting joint investment principles goes too far: thus today's variety of investment possibilities and the related potential for returns would be significantly limited.
Increased transparency requirements for "proxy advisors", in particular the obligation to disclose interest conflicts, facilitate an effective control of their voting rights.

Legal Assessment

Legislative Competence

The Commission's demand that Member States should implement the EU's remuneration recommendations has no legal basis. The European Treaties do not provide for any powers regulating management remuneration. In this case, the EU must restrict itself to making non-binding recommendations.
For the major part of the discussed rules, however, the EU has the power. Rules on shareholders' rights can be based on Art. 50 (freedom of establishment) and Art. 114 TFEU (Internal Market) and a women's quota system on Art. 157 Abs. 3 TFEU (Equality between Men and Women).

Subsidiarity

EU rules on quota systems for non-nationals and women have no cross-border relevance and are therefore **not in line with the principle of subsidiarity.**

Proportionality

Currently not foreseeable.

Compatibility with EU Law

Excluding majority shareholders from decision-taking with regard to significant transactions would constitute an interference with the right to property protected by Art. 17 of the Charter of Fundamental Rights.

Compatibility with German Law

Excluding majority shareholders from decision-taking with regard to significant transactions constitutes an interference with the right to property (Art. 14 German Basic Law). However, this is insignificant due to Art. 17 of the Charter of Fundamental Rights. For the Federal Constitutional Court waives its right to exercise its power where the European Court of Justice ensures a protection of the basic rights in line with the essential parts of the basic right ("Solange II", 2 BvR 197/83; "Lisbon", 2 BvE 2/08, 337).

Conclusion

More transparency in the remuneration policies of listed companies and in the activities of asset managers and advisors make it easier for shareholders to exercise their voting rights. Otherwise, the Commission' proposals should be rejected. Transparency requirements should not be prescribed statutorily. The Commission's assumption that risky thinking and short-termism is generally negative ignores the operating conditions of the market economy. Quota systems for non-nationals and women interfere with the shareholders' property rights and infringe the principle of subsidiarity. Excluding majority shareholders from decision-taking with regard to significant transactions constitute an interference with the right to property protected by Art. 17 of the Charter of Fundamental Rights. A regulatory monitoring of governance statements undermines the "comply or explain" approach of corporate governance codes, which is based on the freedom of decision.