

# Corporate Governance: an EU perspective

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## EU Corporate Governance

### •I. What already existed (post Enron/Parmalat):

- 4th Directive, « comply or explain »
- The Audit Committee (Statutory audit Directive)
- Recommendation on independence of directors
- Recommendation on directors' remuneration
- The European Corporate Governance Forum

### •II. Practical application

### •III. Current developments

- CG study on comply and explain
- CG in Financial institutions

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## I. What already exists (1)

### Legal requirements (Amdts to 4th and 7th Accounting Directives)

- **Confirm collective responsibility of directors with respect to financial statements,**
- **Annual CG statement** for listed companies (*as part of the annual report, together with the annual report or by reference to the company's website*)
  - reference to CG code of application (*mandatory or voluntary*);
  - An explanation to any departure from the CG code (or why the company does not follow a CG code);
  - Description of the main internal control and risk management features
  - Information required under the takeover bid Directive
  - Operation of the shareholders' meeting and its key powers, a description of shareholders' rights and their exercise (*unless info provided by law*)
  - Composition and operation of the administrative, management and supervisory bodies and their committees

## What already exists (2)

### The Audit Committee Art 41 of the 8th Directive on statutory audit

- **Each public-interest entity shall have an audit committee.** The Member State shall determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. **At least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing.**
- In « small » public-interest entities, Member States may permit the functions assigned to the audit committee to be performed by the administrative or supervisory body as a whole, provided at least that **when the chairman of such a body is an executive member, he or she is not the chairman of the audit committee.**

## What already exists (3)

### 2005 Recommendation on independent Directors (1)

- Separation of the role of chief executive director/officer and (supervisory) board chairman
- Independent (non-exec) directors should be in sufficient number on the (supervisory) board;
- Set-up of board committees with a strong presence of independent directors to mitigate conflicts of interest (nomination, remuneration, audit committees);
- High standards on qualifications and commitment of (supervisory) board members
- Transparency on independent board members

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## Recommendation on independent Directors (2)

### Profile of non-exec or supervisory directors:

- The (supervisory) board to ensure it is composed of members, who, as a whole, have the required diversity of knowledge, judgement and experience to complete their tasks properly;
- Members of the audit committee should, collectively, have a recent and relevant background in and experience of finance and accounting for listed companies appropriate to the company's activities;
- Induction training programme for all new members and annual review
- Disclosure of the competences of individual directors and of adequate information on the board's determination of the directors' independence is recommended.

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### Recommendation on independent Directors (3)

#### **Time commitment:**

- Each director should devote to his/her duties the necessary time and attention. As a consequence, this may imply that directors limit their other commitments. Other assignments and significant professional commitments should be disclosed

#### **Independence:**

- The independent director undertakes (a) to maintain in all circumstances his independence of analysis, decision and action, (b) not to seek or accept any unreasonable advantages that could be considered as compromising his independence, and (c) to clearly express his opposition in the event that he finds that a decision of the (supervisory) board may harm the company. When the (supervisory) board has made decisions about which an independent non-executive or supervisory director has serious reservations, he should draw all the appropriate consequences from this. If he were to resign, he should explain his reasons in a letter to the board or the audit committee, and, where appropriate, to any relevant body external to the company.

### Recommendation on independent Directors (4)

- **Evaluation of the (supervisory) board:**
  - Yearly assessment of its membership, organisation and operation as a group, evaluation of competence and effectiveness of each board member + board committees and how well the board has performed against set performance objectives if any
  - (Supervisory) Board to make public yearly adequate info about its internal organisation and its procedures, including whether the self-evaluation has led to any material change.

## What already exists (4)

- **Recommendation on directors' remuneration**

- Statement on directors' remuneration
- Shareholder vote on remuneration policy
- Disclosure of remuneration of individual directors
- Share and share options to be approved by AGM

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## What already exists (5)

- The European Corporate Governance Forum (Oct 2004)
  - 15 high level members (academic world, business world, regulators, professionals) with widely recognised experience and competence regarding corporate governance, mandated for 3 years
  - Role of the Forum: to enhance the convergence of national CG codes and to provide strategic advice to the Commission
  - Series of public statements on: (i) comply or explain principle, (ii) risk management and internal control, (iii) cross-border voting, (iv) proportionality, (v) cross-border issues of corporate governance codes, (vi) director remuneration

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## II. Practical application

- Commission report (2007) on the application of the recommendations respectively on independent directors and directors' remuneration
- Monitoring of the effective application of CG codes (ECGF; FRC network).

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### Practical application re Rec on independent directors

- Comply-or-explain principle widely applied throughout the EU
- All MS require/recommend presence of independent directors in boards. Some differences in the definition of independence: not all MS require independence from the majority shareholders
- Most MS require/recommend separation of the CEO function and supervisory function. However, in a number of MS, former CEO can become supervisory board chairman and so oversee their own past decisions.
- A significant number of MS do not recommend the presence of independent directors in all board committees (particularly remuneration and audit committees)

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### Practical application re Rec on directors' remuneration

- More than 2/3 of MS have introduced high disclosure standards re remuneration of individual directors
- More patchy picture re disclosure of the remuneration policy (*only followed by 60% of MS*) and shareholders say on pay (*only followed by 1/3 of MS*).
- However, most MS have recommended or imposed shareholder approval of share-based incentive schemes

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### III. Current developments

- CG study on comply and explain
- CG in Financial institutions

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## CG study on comply or explain

- Following discussions in the European CG Forum in 2006 and 2007, DG Internal Market commissioned an external study on the functioning of the comply-or-explain principle.
- The purpose of the study is to:
  - describe the relationship in the 27 MS between national legislation and CG codes;
  - examine the existing monitoring and enforcement mechanisms in the MS for codes and to evaluate the effectiveness of these mechanisms;
  - obtain an impression of the companies' perception of codes; and
  - evaluate the perception of EU shareholders as to the quality of companies' disclosures and explanations given, and of their reactions to disclosure perceived as insufficient

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## CG study on comply or explain

- Results of the « study in monitoring and enforcement systems in Corporate Governance in the Member States » to be presented at the CG Conference organised in the context of the Swedish Presidency (Stockholm, 3 Dec 09)
- Summary:
  - Broad support for the comply-or-explain principle among regulators, companies and investors
  - Two main shortcomings:
    - Low disclosure quality of CG company statements (in particular re risk management and remuneration) and lack of comprehensiveness
    - Many investors do not invest the necessary time and resources to provide effective oversight

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## CG in Financial institutions

- Supplementary Commission recommendations on remuneration in the financial sector and on directors' remuneration (April 2009) regarding remuneration structure, governance, disclosure and where relevant supervision
- Amendments to the Capital Requirement Directive (Banking sector) re remuneration structures

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## CG in Financial institutions

- Report (and possibly recommendations) in on corporate governance in financial institutions in Spring 2010
- Possible topics: Board functioning, non-executive oversight, role of shareholders, the risk function, external and internal audit, supervision

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## CG in Financial institutions

- Mentioned corporate governance failures:
  - Boards did not properly oversee senior management and understand and monitor the business (complexity of products and related risk);
  - NEDs were either asleep or unable to challenge the executive directors;
  - Internal risk management was too often ineffective. Boards failed, sometimes for lack of proper information, to adequately define the company's risk appetite, set appropriate limits and monitor them;
  - Most institutional investors tend to consider it is not their role to « police » boards' behaviour and would rather vote with their feet;
  - Remuneration systems in a number of cases failed to promote the company's long term interests;
  - Regulatory supervision remained insufficient and external auditors did not give any alert.

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## Where to find additional information?

- Commission's website at page:  
[http://ec.europa.eu/internal\\_market/company/modern/index\\_en.htm](http://ec.europa.eu/internal_market/company/modern/index_en.htm)
- Or by contacting the Company Law, Corporate Governance & Financial Crime Unit by email at: [Markt-F2@ec.europa.eu](mailto:Markt-F2@ec.europa.eu)

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