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Corporate Governance in the European Union:

A new era in governance activism?

THE EUROPEAN COMMISSION IS PROPOSING a series of corporate governance reforms for EU member countries. As its new governance Green Paper notes, in 2009 the G20 finance ministers and central bank governors emphasized the need for action to ensure sustainable growth and build a strong international financial system. Drawing on the OECD's paper "Corporate Governance and the Financial Crisis," the EU goes on to state that corporate governance is "one means to curb harmful short-termism and excessive risk-taking." The purpose of its Green Paper is to respond to the G20 edict, under the auspices of the European Commission's Corporate Governance and Financial Crime Unit, and propose wide-ranging and long-awaited corporate governance reforms within EU member states.

There are 25 corporate-governance proposals in total, under four general categories: (i) General; (ii) Boards of Directors; (iii) Shareholders; and (iv) Monitoring and Implementation of Corporate Governance Codes. The full text of the proposals is available online, in downloadable PDF format, at the European Commission's website at http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf.

These proposals are comprehensive and represent a major step forward. They address the governance of small and mid-cap companies (SMEs) and unlisted companies (as well as listed companies); the separation of chair and CEO; board diversity; external board evaluations; holding boards responsible for risk appetite; disclosure of director remuneration for shareholder advisory votes; governance of asset managers and proxy advisers (including addressing conflicts of interest); greater shareholder engagement; strengthening the rights of minority shareholders; and possibly strengthening the authority of monitoring bodies to assess listed companies' compliance with governance code provisions.

The overall tone and direction of the EU's proposals are significant because they not only reflect reforms being undertaken in other countries, but go beyond many of these in a prescriptive way, particularly those involving proxy advisers, asset managers, institutional shareholders, minority shareholders, and the role of regulators in overseeing company disclosure.

The 25 proposals are paraphrased as follows:

General Questions:

1. Should the EU take into account a company's size when instituting governance reforms? (For example, there could be a separate code for SMEs, or a certain size threshold above which corporate-governance measures would apply.)
2. Should governance measures be instituted for unlisted companies? Or should they apply only to listed companies?

Boards of Directors:

3. Should the duties and responsibilities of the chair and CEO be clearly divided?
4. Should the recruitment policies of directors (including the board chair) be more explicit about the profile of directors, to ensure that boards have the right skills (e.g., competencies and other attributes)? Should these policies also ensure that the board is suitably diverse?

5. Should companies be required to disclose whether or not they have a diversity policy (e.g., to apply to the board, senior management and the organization) and, if so, should the objectives and progress of the policy also be disclosed?
6. Should companies be required to ensure a greater gender balance on boards (e.g., through disclosure of objectives and progress, quotas, or other mechanisms)? If so, how should this be done?
7. Should the number of board mandates that a non-executive director (NED) holds be limited? If so, how should this be done? This limitation might include consideration of various types of directorships, and whether the NED also occupies an executive position or holds a more time-consuming leadership position, such as chair.
8. Should listed companies be encouraged to conduct externally facilitated board evaluations regularly (e.g., every three years)? If so, how should this be done? (Given that the 2010 U.K. code recommends a similar time frame for externally facilitated board evaluations, this may be a move towards standardizing board evaluations and their timing.)
9. Should disclosure of an organization's board compensation policy and the remuneration of executive and non-executive directors be mandatory?
10. Should the remuneration policy and reports on its implementation be put to shareholders for an advisory vote? (This would constitute a European version of say-on-pay.)
11. Should the board approve and take responsibility for a company's risk appetite and report this appetite to shareholders? Should this disclosure include societal risks (such as risks related to the environment, climate change, health, safety, human rights, etc.)?
12. Should a board take reasonable steps to ensure that the company's risk-management arrangements are effective, and aligned with its risk profile?

Shareholders:

13. Are there any EU legal rules that are contributing to inappropriate "short-termism" among investors? If so, how could these rules be changed to prevent such behaviour? (Short-termism could stem from asset-manager relationships resulting from increased intermediation, automated and high-frequency trading and shorter retention periods, or "regulatory bias" (in the words of the Green Paper) that could cause mispricing, herd behaviour or increased volatility.)
14. Are there measures to be undertaken in regard to the incentives (e.g., fees and commissions based on short-term, relative performance) and performance evaluations of asset managers who manage long-term, institutional shareholder portfolios, with a view to better aligning the interests of asset managers with those of long-term institutional investors?
15. Should EU law promote more effective monitoring by institutional investors (i.e., asset owners) over asset managers (i.e., the agents of institutional investors) with regard to strategies, costs, trading, and the extent to which asset managers engage with investee companies? Should EU governance promote greater transparency of fiduciary duties by asset managers, greater monitoring of activities that are beneficial for the long-term interests of institutional investors, and more active stewardship of investee companies by asset managers?
16. Should EU rules require a certain independence of the governing bodies of asset managers, or are other measures such as legislation needed to strengthen the disclosure and management of conflicts of interest?
17. What is the best way for the EU to facilitate shareholder co-operation? (This refers to the ability of institutional investors – in particular, those with diversified portfolios – to engage with one another without contravening EU laws on "acting in concert." Shareholder co-operation may be facilitated, for example, by setting up shareholder forums (e.g., structured online shareholder communication), or an EU proxy-solicitation system whereby companies establish a specific function on their websites enabling shareholders to post information on certain agenda items and seek proxies from other investors.)
18. Should the transparency of proxy advisers be enhanced (e.g., with regard to analytical methods, conflicts of interest, and whether and how a code of conduct is applied)? If so, how?
19. Are legislative restrictions on proxy advisers necessary (e.g., to restrict the providing of consulting services to investee companies)?
20. Should a mechanism (technical and/or legal) be in place to facilitate the identification of shareholders by issuers, in order to facilitate dialogue on corporate governance? If so, would this mechanism

enhance co-operation among investors? If so, what would be the details of such a mechanism (e.g., the objectives to be pursued, preferred instrument, frequency and cost)?

21. Should minority shareholders be accorded additional rights to represent their interests within companies with a controlling or dominant shareholder? A controlling shareholder (the predominant governance ownership model in European companies) could be an individual, a group of individuals, or a corporation with the ability to exercise a majority of the votes for the election of the board of directors. The word "rights" and "represent" can be interpreted to mean something more than simply augmenting the influence of minority shareholders. The Green Paper identifies difficulties that minority shareholders often have in protecting their interests in companies with a significant shareholder within a "comply or explain" governance regime. For example, certain EU member states have reserved the appointment of some board seats for minority shareholders.
22. Do minority shareholders need greater protection against related-party transactions? If so, what measures should be taken? A "related-party transaction" generally refers to a deal between a company and a related party (e.g., a significant shareholder, an officer, or a director of the corporation) that may involve a conflict of interest. If the board of directors does not take all appropriate action in light of the conflict, or shareholders (all shareholders, including minority) do not have full knowledge of, and the opportunity to approve, a significant related-party transaction, monies or opportunities could be appropriated by the related party at the expense of the corporation and/or minority shareholders.
23. Should measures be taken at the EU level to promote share ownership by employees?

Monitoring and implementation of corporate-governance codes:

24. Should companies departing from corporate-governance codes be required to provide detailed explanations for such exceptions, and describe alternative solutions employed? (Under a "comply or explain" regime, adopted by many countries and widely endorsed for its flexibility, companies may diverge from corporate-governance code recommendations provided there is adequate disclosure, explaining the rationale for the departure and how the practices or actions taken achieve the objective of the principle or recommendation. The issue has been the adequacy of disclosure, for both the "comply" and "explain" planks of the regime.)
25. Should monitoring bodies (e.g., securities regulators and stock exchanges) be authorized to assess the informational quality of corporate-governance compliance statements, and require more detailed explanations as necessary? If so, how should this be done, and what exactly should be these monitors' role?

Conclusion:

The Green Paper provides member states, the European Parliament, and legislators, directors and observers in other countries a preview of what governance reforms, many of which go well beyond other global governance developments, may be emerging within Europe in the coming months. After considering the comments received regarding the Green Paper, the European Commission will move on to extensive impact analysis of its proposed changes.

For interested readers, a group of Canadians responded to 23 of the EU's 25 questions.[1] Composed of academics and practitioners, this group hoped to share relevant experiences and Canadian examples that the EU might otherwise have been unaware of, in the hopes of sparking a transatlantic dialogue to build better global governance.

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1. Their letter may be downloaded at: http://tinyurl.com/icd-EUquestions