ecoDa Conference

Brussels – 9 October 2015

Corporate Governance Compliance and Monitoring Systems across the EU

In April 2014, the European Commission issued a **Recommendation** on the quality of corporate governance reporting (and on the application of the 'comply or explain' principle), demanding that Member States describe their governance monitoring system. ecoDa (The European Confederation of Directors Associations) - in cooperation with Mazars and the European Corporate Governance Codes Network (ECGCN) - have taken the initiative to conduct a **Survey** of the Corporate Governance Codes in force, the monitoring systems developed in the different Member States as well as the status of compliance reporting. On 9 October 2015 ecoDa, Mazars and ECGN organised a joint **Conference** on these themes. As a further complement, this **Report** summarizes the presentations and discussions at this conference.

ecoDa hopes that the European Commission can use this report and the comments received at the conference to: secure a level playing field as to the scope and approach used; foster a better respect for flexibility and rehabilitate the route of explanations; promote a more harmonized approach to monitoring in general and evaluating/stimulating high quality explanations; continue to demand more attention for the decision-making process in respect of governance.

MAIN HIGHLIGHTS:

Joanna Sikora, DG Justice, European Commission, discussed the challenges for the Comply or Explain principle.

"Deviation from the CG Codes can be as good as compliance or even better"

- The Comply or Explain principle was enshrined in EU legislation in 2006. The EU model has real advantages in comparison to the US regulatory approach of Sarbanes Oxley: it gives companies the flexibility to adopt tailor-made approaches and solutions that work best for them. The European legislator showed that it has confidence in national market players and therefore has opted for self-regulation.
- Nearly 10 years later we have a better view of how this mechanism works. Each EU member state has a corporate governance code.
- The ISS report (to which ecoDa has contributed) and the 2012 Green Paper on the CG framework concluded that there is a great support for the Comply or Explain approach; however there are things to be improved in how this flexibility principle works in practice. Comply or Explain should be seen as an opportunity to reflect on a company's situation. The objective of the European Commission is not to reach 100% compliance. On the contrary, the flexibility principle should be used whenever relevant. Deviations from the CG Codes can be as good as compliance or even better, provided there are good explanations (flexibility comes at the price of solid explanations). All market players have a role to play in ensuring the quality of Comply or Explain : shareholders should scrutinize and devote resources (if they are passive, the credibility of the system is undermined), the national monitoring bodies should give guidance and encourage dialogue between companies and investors. With more and more foreign shareholders engaged in European companies, it is important to make them understand the logic of the Comply or Explain principle, so that they can take better decisions.
- ecoDa's report is perceived as a very important study for the European Commission. It shows that corporate governance models are so different, that it is almost impossible to make European-wide comparisons and draw general conclusions. The question remains how to cope with these differences? Today, two diverging opinions prevail: in general, companies insist that

we need to preserve national traditions in corporate governance; investors on the other hand, ask for a more level playing field and more consistency. The European Commission needs to understand both views and find a good balance.

Dorota Lyszkowska-Becher, DG Justice, European Commission, discussed the EC Recommendation on the Comply or Explain Principle.

> ***"The new European Recommendation on CoE is a general encouragement to companies to be more transparent"***

- As it concerns a recommendation, the aim is to give guidance and provide a general (non-binding) framework, while also referring to a number of existing national best practices. There are four main areas of guidance: 1. Provisions to make it easier for companies to report (by providing a clear distinction between different types of provisions in the national codes); 2. Quality of corporate governance reporting in general; 3. Quality of explanations in case of non-compliance (with a comprehensive list of guidelines for comply or explain). 4. Monitoring (pointing out that monitoring needs more attention and (potentially) involves different bodies or parties to be involved, but without further specific guidance).
- According to the Commission, around half of the member states reported to the Commission on how they followed the recommendation by the time of the conference; some were already in line with the recommendation and the others either have recently updated the national rules or were planning to do so in the near future. The Commission hopes to have a clear overview on member states' situation by the end of this year.

Panel 1: "The Comply or Explain Principle: Is there a common level playing field across the EU?"

Lutgart Van den Berghe, Chair of ecoDa's Policy Committee / Executive Director at GUBERNA, said that ecoDa wants to promote good governance practices and considers the flexibility offered by the comply or explain option instrumental for tailoring the governance practices to the needs and challenges of a widely diverse corporate landscape throughout Europe.

> ***"It is very dangerous to make comparisons of compliance ratios across Europe"***

- The ecoDa Study is the first part of a three-part project, aiming to analyse corporate governance compliance monitoring across the EU, the Board's role in designing an effective framework of corporate governance, and the stakeholders' perceptions of governance practices at listed companies.
- There are huge differences within Europe as to the scope of the codes for 'listed companies':
    - Due to highly different degrees of market capitalisation across Europe.
    - Due to different shareholders structures (CoE seems to work better with active (mostly insider) shareholders whereas passive shareholders and small outside shareholders are less interested in these 'nitty gritty' details).
    - Due to different cultures towards self-regulation (the CoE principle originated in the UK).
- Member States usually have one CG Code for listed companies, except for France & Portugal, which have two. CG codes are mostly a combined effort between the private and the public

sector (with emphasis on private self-regulation). The influence of the OECD Guidelines was important at the outset. With the new EU recommendation, all Member States are moving into a more aligned European direction, this is a soft way to harmonize governance practices.

- Notwithstanding this recent trend towards a (very) soft harmonisation, the overall lesson which has been learnt is that today, it is still very dangerous to make comparisons of compliance ratios across Europe. Not only the scope of listed companies widely differs, also the monitoring approach is quite different (different types of monitoring bodies; the scope of the monitoring studies is different; the companies monitored vary in their governance model).
- As regards Comply or Explain, the overall trend is that compliance is considerably increasing. However more investment is needed to improve the quality of explanations. It is easier for the largest listed companies to comply with the CG Codes. If you want to show a good percentage of compliance, you just have to take the largest companies! Most companies that are not complying are not proud of it. They have the feeling that this is not well appreciated. There is no sufficient awareness of CoE in the capital markets. It is important to prove that alternatives serve the same principles. Awards for good explanations could be developed even if it is not so easy to define what good explanations are. What also matters is the governance decision-making process.
- The speaker also stressed that some member states allow companies not to follow any CG code. If companies decide to use that 'loophole' and investors are not objecting, nothing can be done. This is creating an unequal playing field. Foreign investors might not be willing to invest in such companies and this is not good for the economic growth of the member state and the development of the capital market.
- Although CG has been considered for a while as a separate policy issue to company law, nowadays, Corporate Governance is considered as an overall umbrella encompassing both. Even in the OECD guidelines, CG is defined as covering self-regulation as well as the relevant regulatory issues. There is a growing demand for finding the correct balance between legislation, regulation and self-regulation. It will be impossible to regulate all aspects of governance - public transparency is only one mechanism for improving governance structures and practices; we need to be aware of the potential downside of box ticking and window dressing. Rules are not the way forward as to board dynamics and director behaviour. At the same time, there should be no hesitation to take a step backwards if rules do not deliver the intended outcome. But we also have learned that more attention might be needed to achieve objective monitoring of governance reporting.

Chris Hodge, Chair of the European Corporate Governance Codes Network, spoke on the diversity of levels of Corporate Governance in the different Member States.

> ***"There is a need for inspirational best practices to incentivize boards to enhance their behaviours and their decision processes"***

- The Member States did not start from the same point in terms of Corporate Governance. The regulatory framework and the business environment vary a lot from one country to another. It is therefore unrealistic to have one common Code. It makes sense, on the contrary, for the Member States to have different approaches. This does not mean that there is no progress in some Member States but they just start from a different basis. The real measure of success is that all countries are moving in the right direction, which proves that the European Commission was right to place confidence in the CoE system.
- Transparency is a domain where convergence might be more desirable.

- Complying with the CG Codes is often the easiest route. CG Codes become checklists. There is no need for more detailed CG Codes but for inspirational best practices to incentivize boards to enhance their governance behaviour and decision-making process. Boards have to develop their own thinking and confront the compliance mindset in their companies (where it seems to be a worse problem than amongst investors!). This is exactly what the FRC is doing with its guidance on key governance question a non-executive director should ask as well as with its culture project (capturing input from different organisations).

Leena Linnainmaa, Deputy Chief Executive, Master of Laws, Finnish Chamber of Commerce, spoke about the new update of the Finnish CG Code and lessons learned during this process.

> ***"We need to avoid 'wishful thinking' wording and focus more on concrete content"***

- In order to develop the update of the Finnish Code, comparisons were made with different European governance codes for listed companies. This comparison revealed quite a number of interesting observations.
- One needs to fully understand the CG system in each country which is rather difficult if not impossible: most codes don't include a description of the main features of the legal framework. For an outsider it may even be difficult to understand which recommendations require an explanation in case of non-compliance. Therefore, the new Finnish CG Code will integrate a new section to explain the legal system in Finland. It will provide a clear picture of different levels of regulation and soft law, as recommended in the EU Recommendation.
- The UK CG Code is often used as the reference, certainly from the point of view of investors, but not all recommendations are fit for another national market. For instance, the UK CG Code includes strong requirements about the dialogue with shareholders which are difficult to apply in Finland. Codes differ in terms of style and content. In the end, it is like comparing "apples and oranges".
- Most codes contain a lot of self-evident elements, to which all companies will comply. However compliance ratios are difficult to compare because statistics are built very differently.
- The number of deviations has been going down over the past years (one deviation which remains is about gender diversity). Deviations come from small companies who have to comply with the same rules as the larger listed companies.
- Proxy advisors should not apply the same standard model for all types of companies and for all countries. Proxy advisors don't favour departures from the CG Codes. Consequently for non-compliance they give negative voting recommendations for AGMs. This attitude tends to lower the ambition when writing the codes. The Comply or Explain principle would work better with a stronger education of proxy advisors.

Carmine Di Noia, Deputy Director General, Assonime, explained the implementation of the Comply or Explain principle in Italy.

> ***"Corporate Governance Codes are recommendations of best practices not just practices."***

- In 2011 a new Committee was established and a new version of the CG Code was published. According to the CG Code, each Italian listed company adopting the Code: shall provide in its CG Report "accurate, concise, exhaustive and easily understandable information on the manner in which each single recommendation contained in the principles and criteria has been

effectively implemented during the period covered by the report" (guiding principle III) and "clearly state in their Corporate Governance Report which specific recommendations, laid down in principles and criteria, they have departed from and, for each departure: (a) explain in what manner the company has departed from a recommendation; (b) describe the reasons for the departure, avoiding vague and formalistic expressions; (c) describe how the decision to depart from the recommendation was taken within the company; (d) where the departure is limited in time, explain when the company envisages complying with a particular recommendation; (e) if it is the case, describe the measure taken as an alternative to the relevant non-complied recommendations and explain how such alternative measure achieves the underlying objective of the recommendation or clarify how it contributes to their good corporate governance." (guiding principle IV).

- The CG Committee publishes, on annual basis, a report on the general compliance with the CG Code, covering all Italian listed companies.The 2014 CG Committee's analysis contained also a specific focus on the comply or explain principle, analyzing the quality of the explanations provided by all Italian listed companies in case of non-compliance with single Code's recommendations. See here.
- Since 2001, Assonime and Emittenti Titoli have published an annual report on the governance of Italian listed companies and their compliance with the CG Code, having particular regard for company bodies' functioning and composition, internal controls and other governance features which are suitable for an objective assessment. . Moreover, the last analysis provides two specific focuses: directors' remunerations (providing a lot of information due to the quality of the disclosure of Italian listed companies) and the quality of the explanations provided in case of non compliance with some, particularly objective recommendations (boards' and committees' composition; application of independence critera for board members, board evaluation etc.). See here.
- Corporate Governance application is a long journey. Corporate Governance Codes are recommendations of best practices not just practices. Companies have to define the best practices that suit their needs; in some cases even a good explanation of a non compliance (and, even better, the adoption of an alternative practice which suits better to the company structure) may be better than a formal compliance.
- A lot of CG recommendations have shifted from Corporate Governance to company law. CG Codes are sometimes used to test recommendations before integrating them in hard law; in some cases even a good explanation of a non compliance (and, even better, the adoption of an alternative practice which suits better to the company structure) may be better than a formal compliance.

Irena Prijovic, Secretary General, Slovenian Directors' Association, explained the implementation of the Comply or Explain principle in Slovenia. She noted that Slovenia has an overregulated environment which necessitates analyzing interactions of different legislations as well.

"Education on CG Code content is important."

- She highlighted the specific circumstances in Slovenia resulting in a lack of critical monitoring of CG statements: listed companies have highly concentrated ownership with supervisory

board members not engaged in approving the explanations, lack of foreign investors, lack of pressure from the banking sector, etc...

- Although there is an obligation to follow the code, a large number of companies are not using the CG Code at all. However, their number is decreasing over the years (from 38% in 2011 to 28% in 2014 -17 out of 60).
- The Slovenian companies that fully complied with the CG Code were only 5 % in 2011 (with 56,7% providing explanations), and 6,7 % in 2014 (65 % providing explanations). The accuracy of governance reporting and the quality of explanations remains low.
- Possible solutions could be: increased education about CG Code content; Recommendations on quality of explanations; Regular CG reports for Slovenia; Bettermotivation of companies and boards; A national CG monitoring body.
- Recently, the scope for companies to apply CG statements has been enlarged from listed companies to all companies obliged to audit (enlarging the scope from 60 to 1.300 companies!). Consequently, there is need for another reference code. Also State-Owned Enterprises need to follow a governance code and apply the comply or explain principle.

David Herbinet, Partner, Mazars, said that success very much depends on the level playing field. He referred to the basic objectives of Corporate Governance.

"Good corporate governance is about leadership and transparency."

- Companies tend to look more at compliance, not explanations. Board members are keen to show that they are diligent in applying the CG Code.
- Multiplication of codes is not necessary – we need to deliver on original corporate governance objectives. The Cadbury Report from 1992 has set key corporate governance principles: 1. Leadership. 2. Effectiveness. 3. Accountability. 4. Remuneration. 5. Relations with shareholders.
- In order for corporate governance to be successful, national governance codes should be encouraging businesses, boards and investors to be committed to sustainable success rather than focusing on short term return. Boards should choose a governance framework that encourages the creation of sustainable success and be willing to depart from the general code's recommendations if it fits them better.
- Good corporate governance is about leadership and transparency. Focusing on creation of long term value is essential.

Panel 2: "The Comply or Explain Principle: What is the added value for companies?"

Pascal Durand-Barthez, Secretary General of the French High Committee on Corporate Governance questioned who the ultimate beneficiaries of the CoE system are.

"Good explanations are about demonstrating checks and balances."

- We must not lose sight of the ultimate beneficiaries of good governance. Although shareholders or investors are important parties, one cannot neglect the point of view of the company and its (other) stakeholders.

- Flexibility offered by the governance codes requires that very nuanced analyses are made and attention is paid to a tailored solution. The challenge is not to fully comply with the code, but to justify that deviations are coupled with sufficient checks and balances to reach the same outcome. For instance, in France, companies having chair and CEO functions in the hands of a single person should show that an appropriate proportion of independent directors sit on their boards, what decisions are subject to board approval, and that "executive" sessions are organized from time to time.
- It is not good to fix minimum requirements for independent board members. Interpretations need to be made on a tailored basis. E.g. the obligation that an independent director may not have a significant business relationship with the firm is quite different if you are the owner of a large bank or the owner of a small consulting firm. Having a board member sitting on the board for a long period with a CEO remaining the same is not the same situation as having a board member sitting in the board for a long period with the CEO changing all the time. Moreover, it should be up to the board to make up their mind according to the specific needs of their company with the obligation to carefully justify the criteria used. On top of that, boards should periodically review the contribution of each individual director.
- When looking at the proportion of independent board members in the committees or the board itself, and when important shareholders want to sit on the board, what matters is to make sure that minority shareholders are protected.
- In France, employment law is very protective for employees. According to the AFEP-MEDEF Code, CEOs have to end their employment contract if they used to be employed at the company before becoming CEO (in order to give the board more intervention possibilities). This is why they may seek to benefit from golden parachutes to compensate the loss.

Per Lekvall, Board member, Swedish Corporate Governance Board, talked about Comply or Explain as a driver towards improved corporate governance. He insisted on the need to distinguish between the roles of CG Codes versus company law.

"We should have no ambition to reach 100 percent compliance, otherwise we will be risking that codes become mandatory."

- It is too defensive to think that the primary reason for Comply or Explain is to avoid legal regulation. The key aim is to raise the CG level above that required by law.
- There should be a clear distinction between provisions in CG Codes and mandatory provisions in law.
- The speaker was not in favour of the "soft law" expression because it should not be called law in the first place.
- We should have no ambition to reach 100 percent compliance, otherwise we will be risking that codes become mandatory. If approaching full compliance we should instead raise the bar higher for corporate governance. The speaker was also not in favour of the "naming and shaming" concept.
- High quality explanations area prerequisite. The prime requirement for explanations is to be sufficiently informative to the market. Then investors will have to judge the governance practice and the explanations for deviating from the code.
- There is still a lot to be done, but quality of explanations in the EU is improving. Efficient and well-designed systems for the set-up of CG Codes, their enforcement and their monitoring is needed, otherwise the concept of codes will risk losing its legitimacy.

- Given that the context is quite different from one Member State to another, codes should be different. However, the difference in monitoring poses a problem: there is the risk of losing legitimacy. But since codes are not a mandatory regulation, we should encourage a level playing field through private initiatives, like those taken by ecoDa.

Susannah Haan, Secretary General EuropeanIssuers, discussed the key drivers to push companies to fully respect the Comply or Explain approach.

"It is important to bring Corporate Governance to the essence of company strategy."

- Incentives to comply need to be connected to value creation and long term company success. Since companies can be at different stages of development and face different challenges, structures and ownership also governance solutions should very much depend on the individual company.
- Incentives to comply include the value added good governance brings to company, like more attractive terms to raise capital, finding a pro-active solution to succession planning or preparing for growth financing. At the same time also external factors can become important incentives to comply, like peer pressure, investor demands, media and public reputation.
- We also need to talk about the disincentives to comply: regulatory fatigue because of too frequent updates of the codes; lack of thinking time to analyse the challenges and the code principles in depth; scepticism about the bodies promoting the codes (the credibility of the code is better if led by a businessperson); overly detailed codes which are written for lawyers rather than businesspeople.

Prof. Christian Strenger, Supervisory Board Member of Deutsche Asset & Wealth Management Investment GmbH, TUI AG, the Germany Funds (New York), said that the German compliance statistics give the (false?) impression that companies are respecting the code ratherwell.

"Explanations are too often left to legal departments."

- The (formal) code acceptance by companies in Germany today looks rather good. Despite the good statistics, improvements in governance quality are still necessary, particularly for companies that do not go beyond formally accepting the 'Shall-Recommendations' of the Code.
- German corporate governance needs further attention from quite a number of perspectives: A monitoring body or accepted authority for systematic quality control does not exist; the quality of explanations is not part of annual audit; Explanations are mostly lengthy and detailed but only seldom clear; Declarations of 'highly precautionary' non-compliance (despite contrary evidence to the reality) to avoid admittance of non-compliance; Insufficient attention by the media (except financial papers); Non-compliance with a sustainable remuneration policy ifexcessively linked to annual dividends or profits.
- Governance compliance in general and explanations more specifically are too often left to legal departments. Boards usually don't spend much time on it.
- Better ways to ensure sufficient governance quality by companies: Need for best practices for smaller companies (no specific CG code), Regular and intensive board effectiveness reviews by neutral expert (is a better solution than full analysis of the corporate governance report);

Making regular governance education mandatory; Discussions with responsible, long-term investors; Developing peer pressure; Promotion of examples of good governance with contests or awards; The human factor: high importance of tailor-made board selections (particularly the chairperson).

Julie Bamford, Head of Policy, ICSA, talked about the role of the UK Company Secretary in Code Explanations. The UK Corporate Governance Code states "The company secretary should be responsible for advising the board through the chairman on all governance matters."

> ***"Company secretaries have a unique role in the boardroom and they are involved in every stage of corporate governance reporting."***

- The Company Secretary has a key role: advising the board on the requirements of the UK Corporate Governance Code; challenging the board on any alternative arrangements; ensuring the board understands the need for governance safeguards; advising the board on shareholder views; drafting the governance report.
- An example of where the Company Secretary would facilitate a departure from the UK Code and the necessary explanation is Code Provision A.3.1: "... A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report."

Paul Lee, Head of Corporate Governance at Aberdeen Asset Management, talked about Comply or Explain in a global marketplace. There is a general view that Comply or Explain is a European approach, however, it is not entirely true. Similar forms of Comply or Explain exist in Singapore, Malaysia, Japan and in significant portions of markets in Africa and South America.

> ***"We have to acknowledge the benefits of the flexibility approach we have in Europe."***

- In fact, the US is the outlier, with their own very legalistic approach to corporate governance. This is not a healthy path and even Americans are recognizing this. Indeed their approach has created some problems in the US markets and they are very much appreciating the EU markets' flexibility. One damaging effect of the legalistic approach is the confrontational relationship between boards and shareholders.
- Business-led approach is essential. Comply of Explain allows companies to have governance that suits their business cycle. The US Business Start-up Act was revised and the part related to CG was dismantled to free business innovation.
- Institutional investors are pushing for more harmonization but within a framework of huge flexibility. They do not want homogeneity, because they value diversification. Investors want to invest in different types of companies. Corporations need help in understanding what investors want.
- Proxy advisors are there to mediate the relationship between investors and companies. They tick boxes; that's their role.

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