European Corporate Governance in company law and codes

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Chapter 1 – Introduction

In November 2002 we published our report, A Modern Regulatory Framework for Company Law in Europe.1 In the report we addressed a number of corporate governance concerns, many of which were already expressed in the mandate of the High Level Group and others which were particularly submitted to us by the Commission and the ECOFIN Council in the wake of the corporate governance scandals that were brought about in the fall of 2001 and spring of 2002. In our report we outlined a European approach to corporate governance. Key components of this approach are:

- enhanced corporate governance disclosure requirements
- the development of national corporate governance codes in Member States based on a comply or explain mechanism
- EU recommendations to Member States on the strengthening of the role of independent non-executive or supervisory directors and on an appropriate regime for director’s remuneration
- Confirmation of the collective responsibility of board members for the financial and key non-financial statements
- An integrated legal framework to facilitate efficient shareholder information, communication and decision-making on a cross-border basis
- Setting up a structure to co-ordinate the corporate governance efforts of Member States.

These key components have all been included as priorities in the Commission’s Company Law Action Plan of May 2003. The Commission has since undertaken a number of initiatives to develop these components of the European corporate governance approach, among which consultations on board responsibility and improving financial and corporate governance information and on shareholders’ rights and recommendations on strengthening the role of non-executive and supervisory directors and on fostering an appropriate regime of director’s remuneration.2

An important element in this approach is that corporate governance codes should be developed at Member State level and not, for the time being, at EU level. The basic reason for this approach is that the diversity in underlying company law structures and systems in Member States is still so big that attempting to produce a common EU code on corporate governance would either be futile because it would not be able to set out best practices at a level which is of real practical importance, or would become a very complex document containing all sorts of different applications and exemptions to accommodate local practices and rules. A number of Member States have indeed developed, and sometimes revised already existing, codes on corporate governance. It is important that these efforts of Member States are co-ordinated to ensure that they can, over time, provide the basis for a general framework on corporate governance in Europe. As we set out in Chapter 3 this would not necessarily involve a full convergence of every

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2 See http://europa.eu.int/comm/internal_market/company/index_en.htm for an overview.
aspect of governance included in codes. In the process Member States should learn from each other’s experiences. At the European Corporate Governance Conference in The Hague on October 18, 2004 the Commission has announced it has set up the European Corporate Governance Forum to this end.

We have been asked by the Dutch government as current EU President and the Commission, who jointly organise the Conference, to run a session during the Conference on the comparison of national corporate governance codes and their convergence. In preparation of this session we have each written a short overview of corporate governance developments in our own particular countries (Chapter 2). In addition we have made an initial analysis on key questions relating to corporate governance codes, their contents and whether or not they convergence and their place in company law (Chapter 3). In doing so, we have also analysed changes in company laws in Member States. To really understand corporate governance developments in Member States it is not enough to simply analyse the various corporate governance codes. The effects of codes can only be assessed against the background of the company law regimes in which they operate and changes to those regimes.

Our report was presented in draft form to the participants of the Conference in The Hague. We have finalized the paper on the basis of the discussions taking place during the Conference. Chapter 4 contains the conclusions of the conference as drawn by the Chair of the conference Mr. David Wright. We hope this report may offer a first contribution to the work of the European Corporate Governance Forum.
Chapter 2 – An overview of Corporate Governance developments in Company Law and Corporate Governance Codes in Member States
1. Introduction

In March 2001 the Danish minister of trade and industry requested a committee of four businessmen, headed by Mr. Lars Nørby Johansen, to examine if there was a need for recommendations on corporate governance. In the affirmative case, the committee was asked to present a proposal for such recommendations. The committee released its report in December 2001. The report, which contains a number of recommendations forming a code, was immediately made part of the rules for issuers of shares listed at the Copenhagen Stock Exchange. The Stock Exchange recommends that issuers relate to the recommendations in their annual reports. A “soft” version of the comply or explain principle was thus introduced.

The 2001-report gave rise to much debate, but was generally well received. Following up on the report, the Copenhagen Stock Exchange established a committee on corporate governance, also headed by Mr. Nørby Johansen. This committee released a report in December 2003, which includes a review of the recommendations made by the former committee and suggests a number of changes. After a public hearing process, the committee set up by the stock exchange issued a new document, dated June 10, 2004, reflecting those changes to the recommendations, which the committee would propose, given the responses received. At the same time, the committee indicated that it had been asked by the Copenhagen Stock Exchange to continue its work in light of the possible adoption of a comply or explain principle at the EU level.

At this point, issuers of shares listed at the Copenhagen Stock Exchange are requested to relate to the recommendations released in December 2001 (referred to below as the “Nørby Code”).

In addition to the themes discussed below, a number of changes have been made to the Act on Public Companies in the last couple of years, which, among other things, facilitate the exercise of shareholder influence. As an example, companies may now decide to conduct their general meetings and communicate with shareholders on a 100 per cent electronic basis (or they may decide to use modern technology as an option for the shareholders).

2. Board structure and board committees

In terms of board structure, the structure of Danish public companies could be said to be somewhere between the two-tier structure known from German public companies (where the
“Vorstand” is responsible for managing the company while the “Aufsichtsrat” is responsible for supervising the Vorstand) and the one-tier board structure known from e.g. the UK. Under the Act on Public Companies there must be two bodies, the board of directors (“bestyrelse”) and the executive management (“direktion”). The board of directors is elected at a general meeting. However, if a company has employed an average of 35 employees the past three years (which obviously is the case for most listed companies), the employees have the right to elect among themselves a number of members of the board corresponding to 50 per cent of the aggregate number of members elected by the shareholders or appointed by others (according to the articles), and in no event less than two members.

The board of directors appoints the executive management, which is responsible for the day-to-day operations of the company. Important or unusual decisions must be submitted to and be taken by the board of directors.

As it transpires, the board is not just a supervisory body but also concerned with managerial matters. Pursuant to the Act on Public Companies, a minority of members of the board of directors may consist of members of executive management. However, an executive cannot be chairman of the board of directors.

As part of the legislation adopted in connection with the European Company Statute, which gives the companies the choice between a one-tier and a two-tier board structure, the conclusion was reached that, for the purposes of the statute, the Danish model is a one-tier structure.

The use of board committees is not mandatory under company law and the Nørby Code reflects a certain degree of resistance against the use of such committees. One of the main reasons for this is probably that Danish boards tend to be comparatively small and, due to the board’s managerial tasks, closer to executive management than the typical continental European type supervisory board. As a practical matter, the boards of many companies already have a kind of committee composed of the chairman and the deputy chairman (collectively referred to as “the chairmanship”) who meet with executive management on an informal but regular basis. Also, a number of companies have established audit committees and certain other types of committees on a voluntary basis. In any event, it is likely that the revised recommendations will be neutral with respect to board committees.

3. **Role of non-executive directors**

The Act on Public Companies does not distinguish between executive and non-executive members apart from the requirements mentioned above. Consequently, all board members are subject to the same standard of liability and are expected to discharge their duties as a collective body. Also, the members of the board of directors owe their duties to all shareholders and not to any particular shareholder or constituency.
The Nørby Code recommends that a majority of the boards members elected by the general meeting be independent. In order to qualify as independent a board member must not (i) be an employee of the company or have been employed by the company in the past five years, (ii) have been a member of the executive management of the company, (iii) be a professional consultant to the company or employed by, or have a financial interest in, a company which is a professional consultant to the company, (iv) have any other material strategic interest in the company other than that of a shareholder.

The Nørby Code further recommends that members of executive management should not be members of the board of directors simultaneously, which is a more restrictive rule than the one found in the Act on Public Companies (that allows a minority of the executive management to be on the board as well).

Part of the corporate governance discussion in Denmark is concerned with how to strike an appropriate balance between independence and insight. Arguably, those who are independent frequently lack sufficient insight, and that those who have sufficient insight frequently are not independent.

4. Conflict of interest

Under the Act on Public Companies, a member of the board of directors or of the executive management may not participate in any decision regarding agreements between the member and the company or regarding legal action involving the member. Similarly, he may not participate in any decision regarding agreements between the company and a third party or legal action involving a third party if he has a material interest in such agreement or action that may conflict with the interests of the company.

In situations where a conflict of interests exists it is not sufficient that the member in question discloses the conflict. He must abstain from participating in the decision.

The board of directors cannot determine its own fees. Such fees must be presented to the shareholders at a shareholders meeting for approval. Typically, this is done in connection with the presentation and approval of the annual report.

5. Executive remuneration

The Act on Public Companies stipulates that the remuneration of executive management must not exceed what is deemed ordinary, considering the nature and amount of the tasks involved. In addition, the remuneration must be reasonable given the financial position of the company and, if applicable, the group of companies of which the company is part.
According to the Nørby Code, the remuneration of executive management should be competitive and reasonable given the assigned tasks, and the responsibilities connected thereto. The code suggests that there be a relation between the aggregate remuneration on the one hand, and the performance of the executives and the value they have created for the company, on the other hand. Openness and transparency are key words regarding performance-related share-based incentive programs.

Shareholders are generally not required to approve the policy or any specific remuneration. However, an exception applies in the event a remuneration program requires a change of the company’s articles in which case the program would have to be approved by the general meeting of shareholders. Consequently, e.g. warrant programs require the approval of the general meeting. Similarly, the approval of the general meeting would have to be obtained if the program requires that the company buy back its own shares.

Under the Disclosure Obligations for Issuers adopted by the Copenhagen Stock Exchange, issuers that adopt share-based incentive programs must immediately disclose certain information with respect to such programs. The disclosure obligation must include, as a minimum, information on (i) the type of the share-based incentive program used, (ii) the categories of individuals included in the program, (iii) the time of the grant of rights, (iv) the aggregate number of shares underlying the program and the allocation of such shares among the categories of individuals included, (v) the goals pursued by the program, (vi) the period within which rights under the program may be exercised, (vii) the exercise price, (viii) any particular conditions that will have to be met in order for the beneficiaries to exercise their rights, and (ix) the market value of the share-based incentive program, including a description of the valuation method and the basic assumptions underlying the valuation. Also, the adoption of extraordinary bonus programs must be disclosed.

In addition, pursuant to the Annual Accounts Act, the annual report must contain information on the aggregate remuneration (irrespective of the form) paid to the board of directors in the relevant fiscal year. The report must also state any incentive programs that include members of the board of directors or board of management with an indication of the categories of members included as well as the kinds of benefits involved and information necessary to evaluate the program. Also, pursuant to the above-mentioned rules issued by the Copenhagen Stock Exchange, the annual report must contain information on such part of the program that has not been exercised as per the expiry of the relevant financial year, stating the non-exercised parts related to members of the board of directors, members of executive management, and other members of senior management, respectively. According to the Nørby Code, the remuneration of each board member and member of executive management under share-based incentive programs should be disclosed in the annual report.

Compared to most other countries, the salaries and bonuses paid to Danish executives are typically modest, but in particular stock option and similar plans are subject to much public
debate. Some argue that the issue is chiefly a matter of disclosure whereas others point out that increased shareholder involvement is required.

6. **Financial responsibility**

All members of a company’s board of directors are responsible for the correctness and adequacy of financial information released to the public pursuant to the Securities Trading Act and the rules promulgated thereunder.

Board members are measured against a standard of care and to the extent they are deemed to have breached their obligations, they are jointly and severally liable for losses suffered as a result of such breach.

No statutory wrongful trading rule exists, but case law probably supports the conclusion that a wrongful trading rule applies to decisions made at a point where the company is insolvent and there are is, in effect, no real hope that the company will overcome its difficulties.

7. **Institutional investors**

Major institutional investors increasingly pronounce their expectations and demands with respect to companies in which they acquire shares. Corporate governance is clearly on their agenda. They are less visible when it comes to actions at the general meetings, where institutional investors often represent a significant part of the aggregate shares of the company. Typically, they only address the company's board and executive management as well as fellow shareholders once the company fails to perform satisfactorily.

There are no rules that compel institutional investors to exercise their influence as shareholders in a more active manner or disclose their plans with respect to each of the companies in which they hold shares. However, attempts are made to develop standards of good governance pertaining to certain types of institutions, partly inspired by the ideas embedded in the Norby Code. The future will show to what extent these initiatives will have practical implications for the institutions.

Some have argued that institutional investors, who are drivers of the corporate governance discussion and process, ought to consider their own board structures, internal decision processes, etc., which do not always reflect the same degree of professionalism as the institutions themselves expect when they invest in shares.

8. **Regulation of audit**
On 30 April 2003, a new Act on Auditors was adopted. The Act, among other things, implements the Commission’s recommendations with respect to auditor independence and quality control.

Independence of auditors is partly regulated by identifying a range of circumstances which per se would entail that the auditor cannot be deemed to be independent. In addition, a number of circumstances are identified which must be considered carefully, as they may or may not, based on the particular facts of each matter, lead to lack of independence.

As regards listed companies (and certain other companies) it is a requirement that auditors (but not auditing firms) rotate with seven year intervals, and that an auditor who is “out” must be so for at least two years.

In order to avoid that auditing firms become dependent on one or a few major clients, an auditing firm must not obtain more than twenty per cent of its revenues from one client for three consecutive years. Also, the size of an auditor’s fees must not be determined by other circumstances than the work performed.

A resigning auditor shall, if so requested by his successor, inform the successor about the reasons for his resignation. If the resigning auditor has reasons to believe that a member or members of management of the company has committed serious crime he must notify the relevant police authorities.

Other features of the Act on Auditors are the provisions on authorisation of auditors, ownership and control of auditing firms, election and functioning, supervision and quality control, disciplinary bodies, sanctioning and confidentiality.

9. Corporate governance disclosure

As mentioned earlier, the Copenhagen Stock Exchange recommends that issuers relate to the Nørby Code in their annual reports. A very large number have elected to follow the recommendation by the stock exchange. In many cases this is done by including a separate statement where the company’s views on corporate governance and, in particular, the Nørby Code, are explained. Other companies have chosen to deal with the matter in a few sentences.

10. Codes as part of national law, etc.

The Nørby Code is not part of Danish law. It is a set of recommendations to which issuers of shares listed at the Copenhagen Stock Exchange are requested to relate. Failure to do so has no consequences, except that the media or certain investors may alert attention to the fact. There have already been newspaper articles dealing with those companies who comply with the Nørby Code, and those who do not. This focus on part of the media will no doubt continue.
Corporate Governance in France
Company Law and Corporate Governance Codes
by Joëlle Simon

Introduction

Over the last few years, the French corporate governance scene has undergone thorough change, due mainly to private-sector initiative and to a lesser extent to legislative action.

It is necessary to recall that French-style corporate governance was developed at the initiative of business organisation in four stages, around four key milestones: 1995, 1999, 2002 and 2003.

1995 marked the emergence of French-style corporate governance, as a result of actions taken by two associations of enterprises, i.e., on the one hand, Mouvement des Entreprises de France (MEDEF) French Business Confederation, and, on the other hand, Association Française des Entreprises Privées (AFEP).

This initiative was a spontaneous move and was not prompted by any financial scandal. This move reflected an intent to respond to the expectations of new shareholders who acquired shares after the privatisations and the opening of the market to foreign investors.

The VIENOT report heralded the beginning of a gradual process, leading to truly far-reaching change.

In 1999, the second VIENOT report supplemented the first set of recommendations.

In 2002, the publication of the BOUTON report provided MEDEF’s and AFEP’s response to investors’ crisis of confidence in financial markets, following the ENRON case, but also reflected an intent to improve the management, organisation and operation of listed companies and their image among investors. Enhanced information and transparency is at the heart of the BOUTON report, whether as regards off-balance sheet commitments or relationships with statutory auditors.

In 2003, MEDEF and AFEP decided to consolidate all of the recommendations contained in the three reports referred to above, in order to:
- facilitate access to companies, investors and stakeholders
- be in line with the recommendation made by the European Commission, i.e. that each State should designate a benchmark code to which enterprises must conform or in respect of which they must explain to what extent their practices deviate and for what reason.
Institutional investors (AFG) also published their recommendations on the corporate governance issue (in 1998, with amendments in 2001 and 2004).

Moreover, a French Institute of Directors (IFA – Institut Français des Administrateurs) was set up in 2003 principally in order to improve directors’ training.

In addition to this overall approach, various ad-hoc initiatives were taken concerning the remuneration of officers and in particular the transparency of such remuneration.

Finally, it is necessary to emphasise that, contrary to what is claimed by certain observers, the recent scandals that shook the confidence of investors at the international level did not challenge the role of self-regulation in this area, even though the legislature has taken action on certain specific points with the law of 15 May 2001 on new economic regulations and the law of 3 August 2003 on financial security.

Those changes are to be seen in the broader context of the company law reform trend structured around the main lines below:

- giving a contractual nature to the law of unlisted companies,
- facilitating companies’ access to finance (Ordinances of 25 March 2004 and 24 June 2004),
- modernising company law, in particular by allowing for electronic voting at general meetings,
- restoring confidence in the operations of companies and markets,
- improving the sanction system, by substituting civil sanctions for criminal sanctions in the case of formal offences.

While in 1995, it was considered by some that such movement towards corporate governance was a US or UK fad, we may now claim that behaviour has changed considerably.

1. **Board Structures and Committees**

1.1. **Separation of the positions of chairman and directeur général**

The position of the président directeur général – PDG – was subject to some criticism, and certain persons did not hesitate to compare him to a monarch governing by divine right with absolute powers.

This led to the idea of dissociating the offices of chairman and directeur général.

Finally, at the end of heated debate, the legislature in 2001 (law of 15 May 2001 on new economic regulations) decided to leave companies free to choose between two options.

French sociétés anonymes thus now may choose between:
• a one-tier structure with a board of directors:
  ➔ with a président directeur général
  ➙ and with a chairman and directeur général - chief executive officer – CEO -
• a two-tier structure

Certain persons wonder if the formula consisting in dissociating the positions of chairman and directeur général will lead, over time, because of its greater flexibility, to the disappearance of the two-tier structure.

In principle, we note that a number of companies included in the CAC 40 stock market index have chosen this formula in order to prepare the directeur général’s succession.

Contrary to the desires stated by certain observers and to the rule applicable to companies listed on the London Stock Exchange, it did not seem advisable to recommend this formula as guaranteeing better corporate governance.

The directeur général whose office is separate from that of the chairman has the powers that are currently granted to the président directeur général. He thus has the broadest powers to act in all circumstances on behalf of the company.

He must be an individual.

He may be assisted by no more than five directeurs généraux having the same powers vis-à-vis third parties.

1.2. Limitation of the number of offices

The legislature’s idea, by the law of 15 May 2001, was that, in order to ensure sound corporate governance, it is necessary to limit by fiat the number of offices that may be held by chairmen, directeurs généraux and members of the supervisory board.

Enterprises considered that the existing limitations were sufficient and that any additional restriction on the number of offices was to result from a recommendation issued to listed companies.

The combined code recommends that a director performing executive duties should not, in principle, agree to hold more than four other directorships in listed corporations not affiliated with his group.

The next government revised part of these rules by a specific law of 29 October 2002, even before the first law came into force.
The law maintained a number of limits:

- five offices of director in sociétés anonymes having their registered office on French territory, with a group exemption for offices held in controlled companies and in fellow affiliates (provided that they are unlisted),
- five offices of chairman of sociétés anonymes not belonging to the same group, with a group exemption,
- an office of directeur général, plus a second office in a controlled company, whether listed or not, and where and when the first corporate office is held in an unlisted company, another corporate office, i.e. possibly a third office in an unlisted company not belonging to the Group. This provision responded to a strong request made by SMEs.

1.3. **An increase in the board of directors’ powers**

The main purpose of the Ordinance of 24 June 2004 on investment securities is to facilitate French companies’ access to financing by increasing issuers’ freedom, but also by better protecting those holding investment securities.

It is necessary to recall that, under French law, the general meeting of shareholders has major powers that are obviously not challenged by this reform.

Without challenging the principle set by the Second Directive as to the competence of the general meeting, the ordinance extends the right to grant a delegation to the board of directors or to the management board, with a limited right for the general meeting to grant certain powers to the Board of Directors, with a right to sub-delegate.

The board of directors or the management board are able not only (as was already the case since 1994) to define the terms of issuance of securities and effect capital increases within a limit set by the general meeting, but may also initiate capital increases within the limit of a cap determined by the general meeting.

The general meeting retains of course all powers to adapt the delegation according to the type of security concerned.

In order to enable listed companies to move in line with the market, the ordinance also creates a possibility of sub-delegation by the board or management board to the directeur général, directeurs généraux délégués or to a member of the management board as regards the power to effect or postpone a capital increase. At present, such a sub-delegation may only be granted to the chairman.

Moreover, the issuance of ordinary bonds will be streamlined, the right to decide on the issue being henceforth granted to the board of directors or to the management board which will be
entitled to choose between a bank borrowing or a bond issue, with a right to delegate such power.

The board of directors shall be entitled to delegate to the directeur general, or in agreement with the directeur general, to one or more directeurs généraux délégués (and in credit institutions to any person of its choosing), the powers necessary in order to effect the bond issue within a time period of one year and determine the terms of such issuance.

The general meeting may also choose to retain such power.

1.4. Prevention of conflicts of interests

French law has, for a long time, been including a restrictive system for the suppression of conflicts of interest. Under these rules, agreements made between the company and any of its directeurs généraux or directors must be submitted for approval to the board of directors or the supervisory boards and thereafter to a vote by the general meeting of shareholders after hearing a special report of the board of auditors.

Since the law of 2001, this obligation has been extended to agreements made between the company and any of its shareholders holding a fraction of the voting rights exceeding 10% (this threshold was set at 5% in 2001 and was thereafter increased to 10% in 2003) and in the case of a company which is the shareholder of companies controlling it (≥ 40%).

In addition, it is provided that the chairman of the board of directors or the chairman of the supervisory board shall submit a report on agreements covering ordinary transactions made at arm’s length.

Moreover, the list and purposes of these agreements must be disclosed to the statutory auditors, directors and members of the supervisory board.

This useless proposal, intended to protect statutory auditors, will be one more formalistic burden imposed on enterprises, or will remain without effect.

The legislature finally heeded this argument and attenuated the impact of this provision in 2003 by removing from the scope of this provision the agreements that "because of their financial impact are not material to any party.”

If the agreement is actually made in the normal course of business and at arm’s length, then this formal rule is irrelevant. Otherwise, this should be covered by the rules governing related-party transactions.
According to the combined code, a director is bound to report to the Board any conflict of interests, whether actual or potential, and must abstain from taking part in any vote on the related resolution.

1.5. **Development of board evaluation procedures**

The consolidated code recommends that the board of directors meets in order to assess its ability to respond to shareholders’ expectations, by reviewing, from time to time, its membership, organisation and operation (which implies a corresponding review of the Board's committees).

Accordingly, each Board should think about the desirable balance in its membership and that of the committees created from among its members, and consider from time to time the adequacy of its organisation and operation for the performance of its tasks.

The evaluation should have three objectives:

- assess the way in which the Board operates
- check that the important issues are suitably prepared and discussed,
- measure the actual contribution of each director to the Board's work though his or her competence and involvement in discussions.

Once a year, the Board should dedicate one of the points on its agenda to a debate concerning its operation.

There should be a formal evaluation at least once every three years. It could be implemented, possibly under the leadership of an independent director, with help from an external consultant.

More than one half of the CAC40 companies have formalised an evaluation procedure, and ten of them have set up an evaluation procedure entrusted to a third-party consultant.

This is a major move for the proper functioning of the board, as a result of an industry initiative.

1.6. **The role of committees**

While French law refers to the possibility of creating committees, it does not impose or regulate this right. Heretofore, Government authorities have considered that this issue was to be left to self-regulation.

Since 1995, MEDEF and AFEP recommend the formation of committees of the board.

The number and structure of the committees are determined by each Board. However, it is recommended that:

- the review of accounts;
• the monitoring of internal auditing;
• the selection of statutory auditors;
• the compensation and stock option policies and appointments of directors and corporate affairs should be subject to preparatory work by specialised committees of the Board of Directors.

The consolidated code published in 2003 by MEDEF and AFEP clarifies the composition and role of the accounts, compensation and appointment committees.

Such committees have no decision-making power, such power being left to the board, and it has not been found advisable to give such committees any autonomy.

2. Role of Non Executive Directors

Aside from the statutory restriction (dating back to 1966) limiting the number of executive directors to one third of the number of board members, the legislature has not taken any position in order to define what is a non-executive director and to mandate a proportion of non-executive directors.

The consolidated code defines the notion of non executive independent director and the percentage of independent directors which must be equal to one half in non-controlled companies whose capital is held by various shareholders. In others, the rule of a third at least should be observed.

The definition of independence used by the consolidated code is rigorous since “a director is independent when he or she has no relationship of any kind whatsoever with the corporation, its group or the management of either that is such as to colour his or her judgement”.

Accordingly, an “independent director” is to be understood not only as a “non executive director”, i.e., one not performing management duties in the corporation or its group, but also one devoid of any particular bands of interest (significant shareholder, employee, other) with them.

The code lists the criteria that are to be used for a director to qualify as a non-executive director and for preventing conflicts of interests. Independent non-executive directors play an important

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3 Those criteria are the following : *not to be an employee or corporate officer of the corporation, or an employee or director of its parent or a company that it consolidates, and not having been in such a position for the previous five years; *not to be a corporate officer of a company in which the corporation holds a directorship, directly or indirectly, or in which an employee appointed as such or a corporate officer of the corporation (currently in office or having held such office going back five years) is a director; *not to be (or be bound directly or indirectly to) a customer, supplier, investment banker or commercial banker: -that is material for the corporation or its group, -or for a significant part of whose business the corporation or its group accounts; *not to be related by close family ties to a corporate officer; *not to have been an auditor of the corporation within the previous five years; *not to have been a director of the corporation for more than twelve years (as a
role within accounts committees where they must represent two thirds of the members and in compensation and appointment committees where they must represent the majority of the members.

3. Executive Remuneration

The first moves towards greater disclosure were made by the business community. Indeed, already in 1999, CNPF – French Business Confederation - recommended the individual public disclosure of officer compensation.

Even though the business community generally considers that corporate governance issues are not to be settled by provisions of law, it understood that, in the general context of mistrust towards markets, it was necessary to show political resolve in this area.

This being said, many provisions included in the law had already been recommended in the VIENOT I and II reports and in the BOUTON report which we have referred to above.

Nevertheless, the legislature decided to deal with this issue and imposed, by the law of 15 May 2001, for all sociétés anonymes, whether listed or not, the obligation to disclose, in their annual report, the aggregate amount of the compensation and benefits of all types paid to each officer4.

Most fortunately, the law restricted in 2003 this obligation to the sole companies that are listed or controlled by a listed company.

However, the law of 1 August 2003 extended this obligation to all compensation received from companies of which the person concerned is an officer and from any companies controlled by or controlling such company.

The law also mandates the provision of information in a special report on share subscription or purchase options granted to and exercised by the officers of the company and the companies under its control, as well as by the ten employees who have been granted the largest number of options.

Further more, in 2003, MEDEF’s Ethics Committee published the Judgement Principles as regards officer compensation: balance (performance, completeness, benchmark market) business line, consistency, simplicity and stability of applicable rules.

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4 Corporate officers include the chairman, the directeur général or directeurs généraux délégués and the directors in companies having a board of directors (one-tier system), and the chairman, the members of the management board and the supervisory board (two-tier system).
Despite all this, the compensation disclosure issue remains the focus of media, but also political debate. Two bills were submitted by UMP – right wing - and the Socialist Party in order to further increase the constraints weighing on corporate officers in this area.

The second proposal, under which the general meeting would have set the bracket of compensation within the company, has recently been dismissed by the National Assembly.

In practice, we note a clear improvement in information and transparency in this area during the last general meetings.

4. Financial Responsibility

When the enterprise is solvent, directors may be held liable under civil law for breaching statutory and regulatory provisions applicable to sociétés anonymes, for breaching the company’s articles of association or for tortuous conduct.

In the event of bankruptcy, it is possible to institute against one or more de jure officers, including directors or de facto officers of the insolvent company an action for the coverage of any insufficiency of assets, if it is proved that such officers are partly liable for such asset insufficiency (wrongful trading).

The director of listed companies may also be subject to administrative fines in case of violation of the rules imposed by Autorité des Marchés Financiers – AMF - , in particular as regards disclosure obligations.

They may be held also liable under criminal law in the case set forth by law: false balance sheet, misuse of corporate funds, etc.

5. Role of Institutional Investors

According to the financial security law of 1 August 2003, Institutional investors must, when they do not exercise their voting rights, give their reasons to holders of mutual fund units or shares.

6. Regulation of Audit

Duality of statutory auditors, a specific feature of the French system, secures the auditors’ independence. It should be genuine, naturally, in that major issues arising when drawing up the accounts should actually be subject to a double review.

The duration of the term of office, set by law at 6 years, and its renewable nature, also help ensure their independence. But a rotation in signatories of accounts for accounting firms in the
major networks and a time-lag between expiry of the two statutory auditors’ terms of office are especially desirable.

Furthermore, the financial security law of 1 August 2003 has substantially altered the status of statutory auditors and the rules applicable to them.

If we focus on those rules directly related to corporate governance, it is necessary to emphasise the provisions aimed at preventing conflicts of interest.

In particular since the financial security law of 1 August 2003, statutory auditors may not acquire, receive or retain, whether directly or indirectly, any interest in any company when such statutory auditor is responsible for certifying the financial statements of any company controlling or controlled by the company concerned.

Statutory auditors may not render to the person who has appointed them in order to certify financial statements or to the persons controlling or controlled by such person any services that do not fall directly within the scope of statutory audit.

Finally, the law also mandates the disclosure of fees, which was already recommended by corporate governance codes.

In addition, this law has created a Higher Board of Statutory Audit, which reports to the Minister of Justice.

This Higher Board is responsible for supervising the profession and insuring compliance with auditors’ rules of ethics and independence.

The consolidated code published in 2003 has made extremely specific recommendations in this area.

For listed corporations, the statutory auditing assignment should be exclusive of any other. The selected firm should give up, for itself and the network to which it belongs, any consulting activity (legal, tax, IT, etc …) performed directly or indirectly for the corporation having selected it or its group.

However, subject to prior approval from the audit committee, services that are accessory or directly complementary to auditing may be performed, such as acquisition audits, but exclusive of valuation services.

The committee should obtain disclosure of the fees paid by the corporation and its group to the auditors’ firm and network and ensure that the related amount, or the share that they represent in
the turnover of the firm and network, is not such as to affect detrimentally the statutory auditors’ independence.

7. Corporate Governance Disclosure

The financial security law of 1 August 2003 imposes on the chairman of any société anonyme the obligation to disclose in a report attached to the annual report, the mode of preparation and organisation of the works of the board as well as the internal control procedures set up by the company.

The part of the report on the internal control procedures is at the heart of an intense discussion between the business community and the Financial Markets Authority as regards the report on internal control.

The debate also covers the nature of the report: description or evaluation.

The provision of law setting forth that “the chairman reports on control procedures implemented by the company” means that the chairman describes and explains such procedures.

It is necessary to note that the report also covers the mode of preparation and organisation of the works of the board and that no assessment is required in this area.

In January 2004, the AMF very clearly stated its wish to have this approach integrated into a dynamic perspective that would enable issuers to make, over time, an assessment of the adequacy and effectiveness of their internal control.

A first analysis of the 2003 annual report shows that the companies concerned have selected a descriptive approach.

This analysis was confirmed by the Justice Ministry which sets forth, in two ministerial responses published on 15 June and 29 July 2004, that the chairman is not required to evaluate procedures or assess their adequacy or effectiveness.

Furthermore, statutory auditors must submit their observations on the report prepared by the chairman of the board as regards internal control procedures concerning the preparation and processing of accounting and financial information.

As early as 1999, the VIENOT Committee II Report recommended that listed companies disclose specifically in their annual report the recommendations of the VIENOT Committee I and II reports. The 2003 consolidated report further states that: listed corporations should report, with particulars, in their reference documents or in their annual reports, on implementation of
these recommendations and, if applicable, explain the reasons why any of them may not have been implemented.

Furthermore, certain listed companies have set up a committee which is responsible for reviewing the board’s corporate governance practices and proceedings.

8. Codes as part of National Law, Enforcement, Legal Basis

The financial security law of 1 August 2003 sets forth that companies issuing securities to the general public must disclose:

- the terms of preparation and organisation of meetings of the board of directors or the supervisory board
- the internal procedures set up by the company,

in accordance with the terms set forth in the general regulations of the Autorité des marchés financiers – AMF.

Such regulations are currently being prepared.

Such publication forms part of a process for the formalisation of recommendations by the AMF, in the same manner as what was done by the COB as regards best practices.

The AMF must prepare each year a report on the basis of this information. This should provide a further incentive leading enterprises to comply with recommendations related to corporate governance.

The consolidated report on the corporate governance of listed companies confirms the principle “comply or explain.”
1. Introduction

a) Stock Corporation Act and Pending Reforms

In Germany corporate governance has become key in company law reform, academic discussion, and public awareness. In 2001 the “Governmental Commission Corporate Governance” issued a report on “Corporate Governance and Modernization of Stock Corporation Law”. This report contained a great number of reform proposals on a corporate governance code, the board(s), shareholders and investors, corporate finance, information technology and transparency, and accounting and auditing. Most of these reform proposals concern the statutory law, in particular the Stock Corporation Act of 1965. The German government presented a ten-point agenda for strengthening corporate integrity and investor protection on February 25, 2003. In the meantime, several governmental draft reform acts are either under discussion or already in the legislative process. Some will be enacted by autumn or early winter of 2004. The most important among them are:

1) Act on Improved Investor Protection (Anlegerschutzverbesserungsgesetz, AnSVG): deals inter alia with insider trading and market manipulation and liability for untrue financial statements;

2) Draft Act on Sample Procedure for Investor Cases (Kapitalanleger-Musterverfahrensgesetz, KapMuG): introduces procedural rules that allow the combination of several investor cases for deciding certain issues common to the different cases;

3) Draft Act on Liability for Capital Market Information (Kapitalmarktinformationsgesetz, KapInHaG): provides for the personal liability of board members who deceive the capital markets by wrong information;

4) Draft Act on Corporate Integrity and Modernizing on Actions to Set Aside Resolution of the Shareholder Meeting (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrecht, UMAG): meant to curb abusive actions of individual shareholders to set aside resolutions of the shareholder meeting for personal benefit;

5) Draft Act on Reforming Accounting Law (Bilanzrechtsreformgesetz, BilReG): intended to strengthen the independence requirements for auditors;

6) Draft Act on Controlling Accounts (Bilanzkontrollgesetz, BilKoG): introduces a two-tier enforcement of accounting law, first by a newly established private body that will review
suspicious accounts, and second by new powers of enforcement for the Federal Agency for Financial Services Supervision (Bundesanstalt für Finanzmarktaufsicht, BaFin); and

7) Draft Act on Supervision of Auditors (Gesetz zur Fortentwicklung der Berufsaufsicht über Abschlußprüfer in der Wirtschaftsprüferordnung, Abschlußprüferaufsichtsgesetz, APAG): provides for the creation of a professional supervisory body with independent experts to supervise the auditors and strengthens the external quality control.

b) German Corporate Governance Code of 2002

Since February 26, 2002, Germany has had an extensive corporate governance code, the German Corporate Governance Code. This Code contains around 50 recommendations to be observed by the management boards and supervisory boards of German listed corporations. In the meantime, this Code has already been amended by the standing governmental code commission, the Governmental Commission German Corporate Governance Code. This Commission intends to check and, if need be in the light of national or international developments, to adapt the Code, usually once a year. The last changes date from May 21, 2003. In its session of June 8, 2004, the Code Commission refrained from further changes and, in contrast to what some had expected, did not revoke the rule on a suitable deductible for D & O insurance (3.9, infra 2).

As to its content, in a first section the Code addresses the shareholders and the general meeting, and in the last part it addresses the reporting and audit of the annual financial statements. However, the clear emphasis of the Code is on the two boards, the cooperation between them, and transparency. The single most lengthy and important part deals with the supervisory board (tasks and responsibilities, chairman, committees, composition and compensation, conflicts of interest, and examination of efficiency).

The Code works under a disclose-or-comply regime (see infra 9). There is already a broad debate taking place about the Code, its meaning, its consequences, and its reform. One of the controversial topics is liability to investors for nondisclosure and for wrong or incomplete statements under the Code. There is a semi-official commentary book on the Code by the secretary of the Code Commission and other authors (Ringleb et al., Deutscher Corporate Governance Kodex, 2003) and a manual on legal and business corporate governance practice (Hommelhoff/Hopt/v. Werder, eds., Handbuch Corporate Governance, 2003).

2. Board Structure

a) Stock Corporation Act

In Germany there is a mandatory two-tier system, i.e., all stock corporations must have two boards, a management board and a supervisory board. German law will give European
companies the choice between the one-tier board and the two-tier board system in compliance with EU requirements, but this will not be open to other stock corporations, though the discussion in legal academia on such a choice has been going on for some time. Most of the board structure, including labor co-determination at quasi-parity in large enterprises, is minutely laid down in the Stock Corporation Act of 1965 and in supplementing labor co-determination statutes.

Labor co-determination at parity has lately come under sharp attack both by academia, legal as well as economic, and by large business in Germany and from abroad (Ulmer, Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht 166 (2002) 271; Berlin Network Corporate Governance, Die Aktiengesellschaft 2004 issue 4; public statement by the Chairman of the Governmental Commission Corporate Governance Baums). Yet the trade unions, while having many problems of their own, still block legal reform, even though German boards with 20 members are clearly too large and labor co-determination at parity is unique in the European Union (Baums/Ulmer, eds., Unternehmens-Mitbestimmung der Arbeitnehmer im Recht der EU-Mitgliedstaaten, 2004). While the pros and cons of labor co-determination at home remain controversial (though the cons seem to be stronger, see Pistor in Hommelhoff/Hopt/v. Werder, eds., Handbuch Corporate Governance, 2003, p, 157 et seq), the adverse consequences in international competition for attracting companies to Germany are obvious, but played down by politics and trade unions. They thereby act against the best interest of labor itself. It would be much better for Germany to follow the wise Dutch example.

The impact of recent decisions of the European Court of Justice (Centros, Überseering, and Inspire Art) on the compatibility of German labor co-determination with the freedoms under the European Treaty is highly controversial. While it is undisputed that the traditional German seat theory can no longer be upheld within the internal market, it is submitted that German labor co-determination also cannot be imposed on companies that have been created abroad and move their seat to Germany. This is because labor co-determination, while considered a public good, is hardly the only legal means to reach the aim of protecting labor interest, and therefore might not qualify as an exception under the jurisprudence of the European Court of Justice. In Germany this issue is hotly debated.

b) German Corporate Governance Code

Board reform has long been on the agenda in Germany. The Code has taken up many of the reform proposals that are easier to realize by soft law than by mandatory law or even mere fall-back provisions. Given the mandatory two-tier system, a first part of the Code deals with the cooperation of both boards (part 3). The most relevant recommendations concerning the cooperation of both boards are information and reporting duties as specified by the supervisory board (3.4), D & O insurance for both boards with a suitable deductible (3.9), and an annual corporate governance report by both boards (3.10). The recommendations concerning the
management board refer in particular to remuneration (4.2; see infra 3) and conflicts of interest (4.3).

3. Role of Non-executive Directors

a) Stock Corporation Act

In Germany non-executive directors are grouped together in a separate body, the supervisory board. The supervisory board is regulated in detail in the Stock Corporation Act (sections 95-116). There is extensive case law and legal literature concerning the supervisory board. Lately the German Federal Court of Law Instance (Bundesgerichtshof) has considerably stiffened the liability of supervisory board members (ARAG/Garmenbeck case).

b) German Corporate Governance Code

There are more than 20 recommendations dealing with the supervisory board. They concern a number of issues, including long-term succession planning (5.1.2); avoidance of the practice of reappointment before the end of the appointment period (five years as a maximum and as a rule; 5.1.2); chair of the committees (with the exception of the audit committee) with the chairman of the supervisory board (5.2); formation of an audit committee (5.3); composition of the supervisory board by members “who, as a whole, have the required knowledge, abilities, and expert experience to properly complete their tasks and are sufficiently independent” (5.4.1); no more than two former members of the management board in the supervisory board and no affiliation with “important competitors of the enterprise” (5.4.2); no more than five directorships in non-group listed companies (5.4.3); and remuneration (see infra I 3) and examination of efficiency (5.6). The meaning and the relevance of these recommendations of the Code cannot be evaluated for themselves alone, but must be seen in combination with the host of rules of the Stock Corporation Act and its interpretation by the courts and the commentaries.

4. Director Remuneration

a) Stock Corporation Act

The Stock Corporation Act contains only a general formula concerning the responsibility of the supervisory board to make sure that the aggregate remuneration of any management board member bears a reasonable relationship to the duties of such member and the condition of the company (section 87). Of course, this is very vague and needs to be concretized.

Surprisingly enough, there has been hardly any case law concerning this provision. However, this has recently begun to change. The famous Mannesmann-Vodafone criminal proceedings against the
chairman (speaker) of the Deutsche Bank Josef Ackermann, the former head of the German Trade Union Association Klaus Zwickel, the former CEO of Mannesmann Klaus Esser, and others has stirred up the whole country. Directors’ remuneration was suddenly a topic for the tabloids. After a long pretrial proceeding, the lower criminal court in Düsseldorf acquitted the accused, but the attorney general has appealed to the Federal Court of Last Instance (Bundesgerichtshof). It may take considerable time until the court delivers its decision on the case. In the meantime, the discussion is continuing in the context of the Code.

b) German Corporate Governance Code

The Code was originally rather timid in supplementing the law, but in its version of May 21, 2003, it is more demanding (4.2). Upon a proposal of the remuneration committee, the supervisory board is to deliberate on, and check regularly, the structure of the remuneration system. A particularly relevant – but not sole – criterion for the remuneration is the personal performance of each member. The aggregate remuneration is to contain fixed and variable parts which are to be adequate on their own as well as in toto. Stock options are to refer to demanding, relevant parameters for comparison and shall contain caps for extraordinary, unforeseen developments. There is to be full individual disclosure. The latter recommendation has always been highly controversial and remains so (see infra I 8).

As of now, the recommendation has been followed by only nine of the thirty DAX 30 companies. Suspicion has been raised that among those DAX companies, there was a conspiracy not to follow the Code in this respect. They have categorically denied this accusation, but there is now an acrimonious public debate going on about this. The Minister of Justice, Mrs. Zypries, has threatened to initiate a law making such a disclosure mandatory if the Code is not followed by all within one year. In the discussion there are even calls to enact a fixed ceiling by law or fixed relationships between management remuneration increases and labor pay increases. This in turn is criticized by others as a product of what they call the German egalitarian and envy society.

The recommendations as to the remuneration of the supervisory board members have remained unchanged (5.4). The members are to receive fixed as well as performance-related compensation. Performance-related compensation should also contain components based on the long-term performance of the enterprise.

In the light of new case law, it has become doubtful whether these recommendations of the Code as to supervisory board members’ remuneration may be maintained in the future. While the practice of stock options for supervisory board members is widespread, a recent decision of the Federal Court of Last Instance of February 16, 2004, held (real) stock options to be incompatible with the supervisory functions of the board. Whether the court will hold this applicable to phantom stocks as well remains to be seen, but it is rather probable. The decision has been criticized by board practitioners. Indeed, share-based remuneration seems to be an important part
of board remuneration and of supervisory board remuneration, provided of course that the right long-term performance and holding criteria are applied. Yet it is doubtful that the Court will listen to this critique. Insofar, a major change in the remuneration practice of German enterprises concerning supervisory board members may be expected.

5. Responsibility for Financial Reporting

a) Stock Corporation Act

As to responsibility for financial reporting, two of the above-mentioned draft acts are particularly relevant.

First, the Draft Act on Liability for Capital Market Information (Kapitalmarktinformationsgesetz, KapInHaG) would bring individual liability of board members for untrue financial statements (in accordance with the ten-point agenda of the German government). The discussion is turning on the questions of which is more preferable: direct responsibility toward shareholders and creditors or the traditional, indirect responsibility toward the company; whether the liability should be for all kinds of financial statements including annual reports, instant disclosure, financial statements toward the press and on road shows, etc.; and whether there should be collective responsibility of all board members for this information. The draft act provides for personal liability of issuers and board members toward investors, i.e., direct liability. Liability for oral statements is restricted to statements in the general assembly and during information events that have been arranged by the issuer. Furthermore, board members can excuse themselves if they have acted without gross negligence and there is a liability ceiling amounting to double the yearly remuneration received by the board member from the issuer.

The Draft Act on Improved Investor Protection (Anlegerschutzverbesserungsgesetz, AnSVG), which aims at transforming the EU market abuse directive, contains two provisions on liability for false and omitted capital market information by the issuer of financial instruments vis-à-vis third parties and on liability for the publication of untrue inside information.

These acts should be seen in the context of the above-mentioned Draft Act on Corporate Integrity (UMAG). While part of this act deals with codification of the business judgment rule for directors (section 93 of the Stock Corporation Act) in a rather controversial way, the important point here is that it is to lower the threshold for minority actions for special audits and for damages (sections 142 and 146). Accordingly, shareholders holding shares with the nominal value of €100,000 can bring an action, though this action is under the control of the court in order to prevent abuses. The UMAG also curtails abuses of the information right of individual shareholders (section 131).
All this goes together with the reform of prospectus liability. As to the latter, a comprehensive comparative law study for the Federal Ministry of Justice has been made by the Hamburg Max Planck Institute and will soon be released in book-form.

b) German Corporate Governance Code

Liability questions are a matter for legislation. The Code does not deal with this.

6. Role of Institutional Investors

a) Stock Corporation Act

The Stock Corporation Act does not mention institutional investors.

b) German Corporate Governance Code

The Code does not deal with institutional investors specifically, though, of course, the requirements of the Code itself are seen as of great importance for the monitoring function of the institutional investors (see Strenger in Hommelhoff/Hopt/v Werder, eds., Corporate Governance Handbuch, 2004, p. 697 et s.).

The Wall Street rule still seems to dominate the de facto behavior of institutional investors in Germany, but there are prominent cases such as the last Daimler-Chrysler annual general meeting in which institutional investors – including DWS Investment GmbH, Deka, and others – have spoken up and criticized the management. A rather acid public discussion has followed between the chairman of the supervisory board of Daimler-Chrysler, Hilmar Kopper (ex-chairman of the Deutsche Bank), and Christian Strenger, member of the board of DWS (near to Deutsche Bank), (cf. Frankfurter Allgemeine Zeitung, June 3, 2003, No 127 p. 18). This would have been unheard of some years ago.

The ideas of our High Level Group and the European Commission concerning disclosure of voting policies by institutional investors have met with criticism in Germany, but the objections do not seem convincing.

7. Regulation of Statutory Audit

a) Statutory Law

The general rules on statutory audit are contained in book three of the German Commercial Code (sections 316-324). The rules have been extensively commented on by lawyers and
economists. There is also important case law as to these rules. More recently in particular, the independence of auditors has been the subject of court decisions.

Major reforms are going on as to the law of accounting and auditing. The already-mentioned Draft Act on Reforming Accounting Law (Bilanzrechtsreformgesetz, BilReG) contains more than 50 single reforms as to the balance sheet law in the Commercial Act. Particular attention is given to the independence of the auditors (section 319 as amended and a new section 319 a). Much of this, though not all, is due to European law.

Another draft act is the Draft Act on Controlling Accounts (Bilanzkontrollgesetz, BilKoG). This act gives the legal basis for installing an accounting review board formed by the profession but under the control and final enforcement competence of the Federal Agency for Financial Services Supervision. The cooperation of a private professional body with the federal supervisory agency is new and not without problems.

A third draft act also mentioned before concerns better supervision of auditors (Abschlußprüferaufsichtsgesetz, APAG).

b) German Corporate Governance Code

The Code contains a last part on reporting (7.1) and the audit of annual financial statements (7.2). The recommendations on reporting concern interim reports, the observance of internationally recognized accounting principles, the preparation of the accounts within 90 days of the end of the financial year (45 days of the end of the reporting period for interim reports), information on stock option programs, disclosure of third-party companies in which the company has a shareholding that is not of minor importance for the enterprise, and notes on the relationships with “related” shareholders.

The recommendations on the audit refer to the independence statement by the auditor, statements on the extent of consultancy and similar performances by the auditor, and information duties of the auditor toward the supervisory board, in particular concerning misstatements by the management board and the supervisory board on the Code.

8. Corporate Governance Disclosure

a) Statutory Law

Disclosure is one of the most important regulatory instruments. Many elements concerning the company and the board must be disclosed in the annual accounts, and in particular in its annex. Detailed rules on this can be found in book three of the Commercial Code that deals with accounting law.
The Stock Corporation Act contains a provision that bolsters the German Corporate Governance Code by introducing a disclose-or-comply regime (section 161 of the Stock Corporation Act, see infra 9).

b) German Corporate Governance Code

The Code itself relies heavily on disclosure and transparency, for example, as to remuneration, conflicts of interest, equal treatment of shareholders concerning information (including information disclosed abroad), and shareholding by the board members. Of course, disclosure is also a key element of the Code recommendations concerning the reporting and the annual financial statements (7.1 and 7.2).

The Code does not yet contain a recommendation concerning an annual corporate governance statement along the lines envisaged by the High Level Group of Company Law and the Action Plan of the European Commission. The idea of such a corporate governance statement has met with criticism in Germany as being superfluous and in part going too far. In particular, there is opposition against having such a statement audited.

9. Legal Basis and Enforcement of Corporate Governance Code

a) Stock Corporation Act

The Code contains recommendations that are not binding, but are enforced under the disclose-or-comply regime. In Germany this regime is not left to the stock exchanges as in the UK and some other countries, but is bolstered by a new section 161 of the Stock Corporation Act 1965 introduced by the Transparency and Disclosure Act of July 19, 2002. According to this section, the members of the two boards must declare annually whether the recommendations have been and are being followed, or which recommendations have not been followed or are not being followed. This formula has led to uncertainty and discussion as to whether this amounts to an obligation to follow the Code or, if there is a change of policy, to disclose this immediately or only in the next annual reporting period. There is also a broad discussion on liability of the board for untrue disclosure statements.

b) German Corporate Governance Code

Furthermore, the Code contains many suggestions that do not fall under the disclose-or-comply regime. Foreign as well as domestic readers must be very careful to distinguish between recommendations (“soll”/“shall”) and mere suggestions (“sollte”/“should”, “kann”/“can”). The Code addresses listed companies, but implies that much of what is said is useful for non-listed companies also.
In the meantime, there is good empirical information about the degree to which the Code recommendations are being followed in practice (for example, von Werder et al., Kodex Report 2004, *Der Betrieb* 2004, 1377; Oser et al, *Betriebs-Berater* 2004, 1121). Twenty-two of the DAX-30 enterprises report full compliance, with only one disclosed exception. Only 16 of the 60 recommendations are not being followed. Only 9 of the DAX 30 companies follow the recommendation of the Code in this respect. Gerhard Cromme, the chairman of the Code Commission, has reported that out of 72 recommendations of the Code, around 95 per cent are followed by all DAX enterprises. For M-Dax enterprises, compliance is only half as good as for the DAX-30 enterprises. As to the 2003 modifications of the Code, it has been mentioned before that there is broad resistance toward individualized disclosure of board member remuneration. This is also true for the recommendation on a suitable deductible for the D & O insurance (3.9, supra 2), and some expect that the Code Commission may even revise this recommendation in the future.
1. Introduction

In the following paper I will provide a brief overview of the major developments in Italian Corporate Law and Corporate Governance in the last few years, focusing in particular on the recently enacted reform of corporate law (Legislative Decree No. 6 of 2003, which came into effect on January 1st, 2004), which deeply modified the Italian Civil Code, and the Corporate Governance Code for listed corporations, enacted by the Corporate Governance Committee of the Italian Stock Exchange. In this memorandum I will also build on considerations expressed in my previous document of 1st of June 2004.

By way of introduction, a few considerations are due concerning the overall approach of the reform. The reform shifted the existing balance between mandatory and enabling rule, considerably toward the latter: expanding freedom of contract in corporate law, the new regulation relies on the expectation that a market for rules will develop, in which the interaction among the different corporate stakeholders will automatically select the most efficient rules. The legislature has adopted, in other words, regulatory competition theories as a basis to reform the Italian corporate scenario. To provide for an overall evaluation of the reform is far beyond the goals of this short paper; however, it is necessary to point out that even the more strenuous advocates of regulatory competition in corporate law, seem to acknowledge that an efficient market for rules can develop only if mandatory disclosure is provided. In this respect, however, not only the reform did not increase the quality of corporate disclosure, but – considering the most recent innovations in white collar crimes in Italy – quite the opposite can be argued, since criminal liabilities for the publication of misleading or false financial statements and prospectus have been significantly curtailed.

With this general premise, it is now possible to discuss more analytically the single issues that we have been requested to take into account, and in particular: i) board structure and auditing; ii) role of non-executive directors; iii) executive remuneration; iv) directors’ conflicts of interest; v) financial responsibility; vi) role of institutional investors; vii) enforcement of corporate governance codes and corporate governance disclosure.

2. Board Structure and Auditing

The recent reform introduced several important new rules in corporate governance. One of the most striking innovations is the provision of three alternative systems of governance among which the parties can choose, according with regulatory competition theories.
In addition to the traditional system of governance, inspired by the French tradition (composed by a board of directors and a board of auditors both appointed by the shareholders’ meeting), in fact, a two-tier and a one-tier systems have been introduced, the former inspired by the German experience and the latter by the Anglo-Saxon one.

In the two-tier, or “dualistic”, system, the shareholders’ meeting appoints a board of independent supervisors, and this body appoints and removes the members of the board of managers, entrusted with the managing of the corporation. The board of supervisors might be characterized as a body in between the shareholders’ meeting and the board of auditors in the traditional model, in the sense that in addition of the usual controlling function performed by the board of auditors, the board of supervisors also approves the balance sheet of the corporation and other issues that, in the traditional system, are dealt with by the shareholders’ meeting.

As for the one-tier, “monistic” model, in this case the shareholders appoint a board of directors, but at least a third of its members must have the same independence requirements of the auditors. Among the independent directors the board itself must appoint an auditing committee, similarly to the US and British approaches.

In the present paper, while I will point out the distinctive features of the new systems and the issues they might raise, I will focus on the traditional system, both because, as a matter of practise, it is very likely that it will still be by far the most widely used, at least in the next few years and, secondly, because most of the considerations that can be raised concerning the traditional system can easily be extended to the alternative ones. Actually, a possible general critique of the new systems is that they are too much the “carbon-copy” of the traditional one, in which the overall organization appear to have changed, but the different bodies remain, in terms of composition and functions performed, exactly the same.

A few words on the controlling functions performed by the different auditing bodies are necessary. In 1998, the so-called Testo Unico della Finanza introduced, for listed corporations, the rule that the controlling body in the traditional system of governance (the only existing one in 1998 under Italian law), would no longer perform accounting control, but on the contrary would control the overall adequacy of the systems of information and accounting and reporting of the corporation, while accounting control would have been performed by the external auditor only. The reform of 2003 extended this approach to all corporations, listed and not listed, with the only exception of non-listed corporations that are not holdings of a group (more precisely, who are not obliged to publish consolidated balance-sheet), which – in case of adoption of the traditional system of governance – can opt out of this rule and entrust the internal board of auditors of accounting control also. In the new systems of governance, on the contrary, accounting control is necessarily and always performed by an external auditor.

As for composition of the managing and controlling bodies, it must be pointed out that the Civil Code provides for independence requirements only for members of the board of auditors (or the
corresponding controlling bodies in the new alternative systems – see art. 2399 of the Civil Code). On the contrary, it is the corporate governance Code enacted by the Italian Stock Exchange, applicable to listed corporations on a “comply or explain” basis, which provides for independence requirements for members of the managing board. While it is not necessary, in this context, to enter into the technicalities of the definitions of independence contained in the Civil Code with respect to members of the controlling board, and in the Corporate Governance Code with respect to directors, it must be pointed out the somehow irrational result that the latter are, overall, stricter than the former.

The Civil Code does not provide for committees internal to the board of directors, with the only exception of the so-called “executive-committee” (for which the regulation is, in any case, very slim), and the audit committee just mentioned in case of adoption of the one-tier model. It is the Corporate Governance Code, on the contrary, to provide for, in listed corporations, three committees: the nomination committee, the remuneration committee and the internal audit committee. The functions of the latter overlap with the audit committee provided for by the Civil Code in case of adoption of the monistic system, with the difference that the audit committee regulated by the Corporate Governance Code performs consulting functions on the auditing system, as well as controlling functions. In this respect it must be observed that a consulting function might impure the independency required to properly control the effectiveness of the auditing system.

3. Role of non executive directors

The Corporate Governance Code introduced, in Italy, an explicit requirement – at least for listed corporations – that the board of directors should be composed by an adequate number of non-executive directors, defined as directors without any executive power within the corporation. No statutory requirement of non executive directors is provided under Italian law, however the recent reform, for the first time (art. 2381 and art. 2392 of the Civil Code), attempts to distinguish roles and responsibilities of executive and non-executive directors, in particular regulating the circulation of information within the board. For non-executive directors, the law mandates controlling duties, establishing also corresponding information-gathering powers, necessary to exercise control over executive directors.

The issue of non-executive directors is linked to the one of independent directors. In fact, according to the Corporate Governance Code, an adequate number of non-executive directors shall be independent (art. 3 of the Corporate Governance Code) from the directors of the corporation, the group to which the corporation belongs and its controlling shareholder(s). Similarly, under the new statutory rules, in case of adoption of the monistic model, the controlling committee internal to the board of directors shall be composed of independent and non-executive directors (according, however, to the slightly different definition of independence contained in art. 2399 of the Civil Code).
In this respect, the role of independent, non-executive directors might be increased, for instance providing for a sort of non-binding opinion of these directors on certain key corporate issues, which can affect deeply the life of the corporation.

4. Executives Remuneration

The Civil Code simply provides that the remuneration of the directors should be established by the shareholders’ meeting (or by the board of supervisors in case of dualistic model). According to art. 2389 of the Code, however, the remuneration of executive directors – or directors with particular duties – might be determined, within the maximum and fixed amount pre-determined by the shareholders’ meeting, by the board of directors itself. The remuneration of the directors might be represented, also entirely, by a participation in the profits of the corporation or in stock option plans.

The Corporate Governance Code provides that the board of directors shall form a committee on remuneration and stock option or equity based remuneration plans. The majority of the members of the committee must be non-executive directors. The committee is entrusted with proposing to the board the remuneration of the executive directors and “of those directors who are appointed to particular positions”.

5. Directors’ Conflicts of Interest

New art. 2391 of the Civil Code introduces an innovative regulation of “interested directors”. The rule provides that if a director has an “interest” (also if not a “conflicting” one) with the corporation, she must disclose it to the board of directors and to the board of auditors, providing for specific information regarding the nature, the origin, the importance and the extent of the interest. Once the interest has been disclosed, the directors can participate in the board meeting and even vote on the issue on which she is interested, but the board must provide for a detailed motivation of the resolution approved in presence of one (or more) interested directors. It is important to point out, however, that if (i) the interested directors fails to disclose her interest, the board’s resolution is not properly motivated, or the resolution would not have been approved without the vote(s) of the interested director(s); and (ii) the board’s resolution might be considered even only potentially harmful for the corporation; than dissenting board members might challenge the resolution and the interested director(s) will be liable for any damage caused to the corporation.

The rule briefly described, which assumes a board’s meeting and resolution, would not be applicable with respect to those matters that an executive directors could decide alone. In this case, therefore, art. 2391 of the Civil Code provides that the interested director must abstain from the decision and defer the issue to the collegiality of the board.
For listed corporations, these rules need to be coordinated with art. 11 of the Corporate Governance Code. This rule provides, in the relevant part, that “Directors who have an interest, even if only potential or indirect, in a transaction with related parties shall: a) promptly inform the board in detail of the existence of the interest and of the related circumstances; b) abandon the board meeting when the issue is discussed”. As a consequence, at least according to the self regulation of listed corporations, interested directors should neither be allowed to vote on the subject matter on which they have an interest, not to participate in the discussion concerning such an issue.

6. Directors’ Liability

Rules concerning directors’ liability are not particularly efficient in Italy: too tight for certain aspects and too flexible for others. On the one hand, in fact, at least until the recent reform there was no clear distinction, either in the Civil Code and in case-law, between the role of executive and non-executive directors. In case of mismanagement of the former, in fact, the latter where almost automatically considered severally and jointly liable with executive directors, on the theory that the very damage cause was the demonstration of their lack of surveillance. This was particularly true in case of insolvency, when the trustee in bankruptcy often seeks to include in the procedure as many debtors as possible.

On the other hand, civil procedure rules are particularly unfavourable to creditors and minority shareholders: a part from the very length of trials, no discovery mechanism is provided for in Italy, with the consequence that any non-insider-plaintiff is at a serious disadvantage, information-wise, with insider-defendants.

7. Role of institutional investors

The role played by institutional investors, in Italy, is not very significant. With few exceptions, institutional investors do not actively participate in the governance of listed corporations, not even to appoint directors or approve important financial transactions, not to mention assuming contrasting initiatives, such as litigation. This is so true that some Italian scholars suggest that institutional investors should be legally compelled to exercise their voting rights, in order to incentive their use of “voice” rather than “exit”. While I do not support such a measure, that seems too rigid, the absence of active institutional investors is a reality.

The causes of this situation are many, and clearly can not even be summarized in this memorandum: they go from the overwhelming role of banks in financing listed corporations versus the market, to the fact that judicial remedies in Italy are – for many reasons –, almost impossible to activate for minority investors, even if they are professional investors such as mutual funds.
In listed corporations, art. 148 of the Testo Unico della Finanza of 1998 provides for the necessary presence of (at least) one member of the board of auditors appointed by minority shareholders. The pending draft statutes on financial markets (whose destiny is, in these days, most uncertain) might provide for a similar representation of minorities also in the board of directors. Such a rule might increase the participation of organized minorities, and in particular institutional investors, in the managing of the corporation, but it must be pointed out that this very provision has already been criticized because, if it is not carefully drafted, it might simply open the door to professional “blackmailers”, who would seek a seat in the boards of listed corporations only to extract private benefits from their position.

8. Enforcement of Corporate Governance Codes and Corporate Governance Disclosure

The Italian Code of Corporate Governance is not binding. Listed corporations are required to either adopt it, or to explain the reasons why they considered its adoption not necessary. Although almost all listed corporations have adopted the Code, its formal “adoption” does not necessarily imply rigorous respect of its provisions. While theoretically communicating to the market the adoption of the code without actually doing it might be considered a false statements arising civil and criminal liabilities, the chances of suffering any serious consequences are extremely low. As a consequence, it is not rare that a listed corporation adopts the code, but fails to implement – or, more precisely, to implement properly –, for instance, the remuneration committee.

On the other hand, on the basis of the listing standards provided by the Italian Stock Exchange, listed corporations must issue, every year, a report on their corporate governance, disclosing specific information concerning the organization of the board and compliance with the Corporate Governance Code. Failure to obey to this rule might result in pecuniary and reputational sanctions inflicted by the Stock Exchange, even though, at least so far, no such a measure has been taken against an issuer.
I. Introduction

A number of recent regulatory developments are reshaping the corporate governance landscape in the Netherlands.

1. On December 9, 2003 the Dutch Corporate Governance Committee chaired by Mr. Tabaksblat issued the Dutch Corporate Governance Code ("the Code") applicable to all listed companies with registered offices in the Netherlands. The Code contains principles, which are to be applied without exception, and best practice provisions, which can be deviated from if such deviation is explained in the annual report. The Code is to be applied as of financial year 2004, and compliance will have to be reported in the annual report 2004 for the first time. The Code has received a basis in company law on the basis of which the government will issue a regulation requiring listed companies to comply with the Code or explain deviations in their annual report (see 8 below).

2. On July 5, 2004 an Act was passed in Parliament to amend the Dutch Civil Code, in particular with respect to the so called structure regime, providing for employee co-determination in larger companies. This Act has made amendments to the co-determination regime as a result of which supervisory directors are now appointed by the general meeting of shareholders out of a nomination made by the supervisory directors themselves. The works council can make a special nomination for a maximum of one third of the supervisory board members. Supervisory directors can be dismissed collectively by the general meeting. The Act has also been used to introduce new corporate governance rules for companies in general, introducing amongst others new powers of the general meeting of shareholders (prior authorization of major transactions, adoption of remuneration policy and approval of share based remuneration schemes, and new powers of shareholders (extension of right to submit proposals to general meeting of shareholders, ability to vote on basis of proxy for holders of depository receipts).

3. A draft for an Act to implement the SE Statute has been submitted to Parliament, particularly relevant for the one-tier and two-tier board structure.

4. A report commissioned by the government on creating more flexible and simple company law for private companies has been published in April 2004 and will be implemented by the government. It will lead to a sharper contrast between listed companies and private companies.
5. A draft for an Act has been submitted to Parliament that will introduce supervision of the annual accounts and reports of listed companies by the securities regulator, the AFM. This is relevant for the enforcement of the comply or explain mechanism on which the Code is based (see 8 below).

6. A paper has been published by the government in August 2004 indicating further amendments to company law, dealing with the structure regime, which will be fundamentally overhauled, using other regulatory instruments to keep company law sufficiently flexible, restoring the balance of power in listed companies and the regulation of takeover bids.

II. Specific topics

1. Board Structure

The typical board structure for listed companies is a two-tier board structure with a separate supervisory board. Companies not subject to the structure regime (companies heading a group of which the majority of employees is working outside the Netherlands are exempt from the structure regime; the majority of the larger listed companies is in fact exempt) need not have a supervisory board and could adopt a one-tier board structure. Some companies have adopted the one-tier board regime recently.

The Code assumes the applicability of a two-tier board structure but contains a number of provisions specifically dealing with the one-tier board (e.g. separation of CEO and Chairman, the majority of the one-tier board must be non-executive and independent in accordance with the criteria of the Code). The draft Act to implement the SE Statute does not contain provisions of substance on the one-tier board and leaves it to general company law (and the Code) to develop the concept and implications of the one-tier board.

The Code provides that the supervisory board must set up an audit committee, remuneration committee and nomination committee, by definition consisting of supervisory directors only. For a one-tier board the Code provides that these committees must all consist of non-executive directors only. Separate committees need not to be set up when a supervisory board consists of four members or less. The Code provides that the committees´ role is to prepare the decisions to be taken by the full (supervisory) board. It is not altogether clear what this implies in practical terms for the responsibility and liability of members of these committees and the board members who are not member of a particular committee.

2. The Role of Non-Executive Directors

The Dutch Civil Code provides that the supervisory board has two main duties: to advise the management board and to supervise the management board. The Dutch Civil Code does not
provide what this should entail in practice. The Code contains a number of provisions in this respect. These provisions are in line with the Draft Commission Recommendation on Strengthening the Role of Non-Executive or Supervisory Directors, as posted on the EU Commission’s website on July 27, 2004, but usually are more specific and sometimes more stringent. The main provisions include:

- A regulation of the supervisory board sets out its modus operandi
- The annual report contains a report of the supervisory board on its own functioning
- The supervisory board and its members have a responsibility of their own to gather such information from the management board and the external accountant as is required to perform their duties as supervisors. They can gather information from employees of the company and external advisers directly
- All members of the supervisory board, with the exception of maximum one member, need to be independent according to criteria set out in the Code, which include:
  - No employee or executive director in five years before appointment
  - Receiving personal compensation other than for the role of supervisory director
  - Having had an important business relationship with the company in the year before the appointment (including advisers such as lawyers, consultants, accountants, bankers)
  - Owning ten percent or more of the company’s share capital, or being a board members of a company owning ten percent or more of the company’s share capital
- All members of the supervisory board follow an induction programme after appointment
- A maximum of five supervisory or non-executive directorships with Dutch listed companies
- The chairman of the audit committee is not the chairman of the (supervisory) board
- The audit committee consists of at least one financial expert
- The chairman of the audit committee is not the chairman of the (supervisory) board, nor a former executive director of the company nor an executive director of another listed company
- Supervisory directors are not remunerated with shares or share options

3. Executive Remuneration

In 2002 the Dutch Civil Code was amended to introduce a requirement for so called 'open companies' (including listed companies and other companies without a restriction on the transfer of shares) to disclose the remuneration of individual managing and supervisory directors. The recent Act to amend the structure regime includes further provisions on director remuneration:
• The remuneration policy regarding executive directors needs to be adopted by the general meeting of shareholders. The individual remuneration of executive directors can be set by the (supervisory) board within the remuneration policy. The adoption by the general meeting not only means that it can reject a remuneration policy as proposed by the (supervisory) board, but also that it can make such amendments as it deems proper.

• Share based schemes for executive directors require approval of the general meeting. Again the grant of shares or options to individual directors can be made by the (supervisory) board.

These elements have been included in the Civil Code in order to ensure that they are mandatory. The Code contains a number of provisions on or related to executive remuneration. The most important of these are:

• Executive directors are appointed for four year periods
• Severance pay to executive directors should not exceed one year base salary, unless this is manifestly unreasonable for a director in his first term of appointment, in which case the maximum is two years of base salary
• An annual remuneration report must be included in the annual report, specifying amongst others the relationship between fixed and variable pay, performance criteria applied for variable pay, peer group which is used as benchmark (much of which is now also included in Draft Commission Recommendation on Fostering an Appropriate Regime for the Remuneration of Directors, dated 27 July 2004)
• Important elements of remuneration agreed with executive director are disclosed forthwith.

4. Responsibility for Financial Reporting

Both the executive board and the supervisory board have a responsibility for the financial reporting of the company. The executive board is responsible for the quality and completeness of the financial statements and the supervisory board must see to it that the executive board fulfils this responsibility. Members of both boards can be held personally liable for damages by shareholders and creditors in case the financial statements are misleading. There are also criminal penalties when financial statements are misleading. There is only very limited and old case law on both the civil law and criminal sanctions, but a few recent cases are now under consideration by courts.

The Code has introduced provisions on the role of the audit committee and the external auditor in the financial reporting process. (see also 6 below).

The new Act that will introduce supervision on the annual accounts of listed companies by the AFM will certainly have an impact on the financial reporting by listed companies. The AFM will have the authority to investigate the financial statements of the company. If it feels the
statements are incorrect it can request the company to revise the statements. If the company refuses to revise the statements, the AFM can file a suit with the Enterprise Chamber of the Court of Appeal in Amsterdam to request an order to revise the statements.

5. **Role of Institutional Investors**

The Code provides that institutional investors have a responsibility to make a considered use of the voting rights on shares in listed companies held by them. Institutional investors like pension funds, insurance companies, investment funds and investment managers, should disclose on their website their voting policy with respect to shares they hold in listed companies and that they must report annually on their website or in their annual report on the execution of their policy. They should also at least once every quarter report on their website whether and how they have voted as shareholders. We have seen some larger institutional investors (pension funds, insurance companies and investment funds) starting to report on their policy and actual voting behaviour.

The Corporate Governance Commission has recommended to the government to include such requirements in the legislation relating to such institutional investors. The government has indicated it is considering to do so in the near future.

6. **Regulation of Audit**

The Code contains a number of provisions relating to the audit of financial statements of the company, in particular on the role of the audit committee and the external auditor. Some key elements:

- The audit committee is responsible for supervising the executive board with respect to the internal control and risk management system, the financial reporting procedures, the relationship with the external accountant, in particular his independence and remuneration
- The audit committee is the first point of contact for the external accountant when he finds irregularities in financial statements
- The chairman of the (supervisory) board is not the chairman of the audit committee
- At least one financial expert sits on the audit committee
- At least once a year the audit committee meets with the external auditor without members of the executive board
- The external auditor is appointed by the general meeting, upon the nomination of the (supervisory) board. The audit committee and the executive board advise the (supervisory) board on the appointment
- The external auditor is present at the general meeting and can be asked questions by shareholders about his certification of the accounts
- The executive board and the audit committee report annually on the relationship with the external auditor, in particular on his independence (including the desirability of partner
There are no current plans to include any of this in legislation, but this may follow from the adoption of the Draft EU Directive on Statutory Audit.

7. Corporate Governance Disclosure

The Code provides that the key elements of the corporate governance are set out annually in a separate chapter of the annual report, with reference to the principles and best practice provisions of the Code. The chapter should explicitly indicate where the company does not comply with the Code and the reasons for that. Any substantial change in the corporate governance and the compliance with the Code needs to be discussed as a separate agenda item in the shareholders meeting. No shareholder vote is required on such changes, but companies can consider to ask specific approval of the general meeting for such changes.

The Code contains a number of specific provisions requiring certain governance disclosures in either the annual report or on the company’s website, e.g. the supervisory board’s regulation and the regulations of its committees, a regulation of the (supervisory) board on trading in shares in Dutch listed companies by executive and supervisory/non-executive directors. In addition, the Code provides that all information the company is required to disclose under applicable company law and securities law and regulations, must also be posted on the company’s website.

As set out in the introduction, the Code has received a legal basis in company law, through a provision in Book 2 Dutch Civil Code, authorising the government to issue a regulation on additional requirements for the annual report, amongst others relating to the compliance with the Code. It is expected that such regulation is issued in the fall of 2004 and will require companies with registered offices in the Netherlands, whose shares are admitted to trading on a regulated stock exchange (not limited to the Netherlands) to comply with the Code or to explain in the annual report to what extent and why the deviate from it.

8. The Code as Part of National Law, Monitoring and Enforcement

See 7. above. As to enforcement of the Code, the Code itself distinguishes between the substance of compliance and the reporting on it. The substance of compliance ultimately is to be judged by shareholders, who can use their normal powers (dismissal of executive and/or supervisory directors, adoption of amended remuneration policy, refusal to grant formal discharge etc.) to influence the board(s) to change the corporate governance and the way the company complies with the Code. The starting point is that companies are not required to comply with the provisions of the Code, but recent case law indicates that there may be generally accepted principles of good corporate governance which are mandatory. Some elements of the Code may
qualify as such. As to the reporting on compliance with the Code, there are additional regulatory
tools that can be applied. The external auditor has some, limited, role on checking whether the
annual report is not inconsistent with the annual accounts and does not report facts or
statements that he knows to be untrue. Similarly, the AFM will have supervisory powers on the
published annual report, may request the company to change its report in certain aspects or ask
the Enterprise Chamber to order the company to make such changes.

The Corporate Governance Committee has recommended that the government set up a
permanent committee on corporate governance that should monitor compliance with the Code
and review from time to time (at least every three years) whether the Code should be amended or
supplemented. Such a committee is now being set up. The permanent committee, like the original
Corporate Governance Committee, will consist of members from business, shareholders, trade
unions and academia.
Corporate Governance in Spain
Company Law and Corporate Governance Code
by José Mª Garrido García

I. Introduction

In January 2003, a new report on corporate governance (the “Aldama Report”) was presented to the Spanish Government, who had commissioned the report in June 2002. The topics covered by the report are far reaching, as the official name of the Aldama Commission shows: “Commission to foster transparency and security in the financial markets and in listed companies”. Thus, the report includes not only recommendations on corporate governance for listed companies and participants in the market, but also legislative proposals.

Most of the legislative proposals have been well received by the Government, and in July 2003 a new Act was passed by Parliament, “the Transparency Act” (17.7.2003). The Act codifies directors’ fiduciary duties, including instances of special rules for the duty of diligence and for the duty of loyalty. Moreover, the Transparency Act creates a legal infrastructure for corporate governance recommendations and corporate governance disclosure. These provisions have been developed further by a Ministerial Order and a CNMV (Spanish Securities and Exchange Commission) regulation. According to all these instruments, companies have to pass an annual corporate governance report, whose content is very much in line with the annual corporate governance report envisaged in the High Level Group of Company Law Experts Report (“the Winter Report”). Besides, the rules establish the duty of having a website in order to publish all kinds of relevant information and to allow the exercise of shareholders’ rights, specially information rights. The CNMV is formally charged with control over corporate governance in general and over corporate governance disclosures, in particular.

The corporate governance recommendations in the Aldama report deal mainly with the general meeting and the board of directors. Apart from the recommendations to introduce legislation dealing with directors’ duties and transparency in corporate governance, the corporate governance recommendations take for granted that self-regulation in corporate governance is to be preserved, with some minor exceptions. In this respect, the Report recommends that listed companies pass general meeting regulations, as well as internal regulations for the board of directors. As regards recommendations for the board of directors, the report builds on the experience and insights of the previous corporate governance report (Olivencia, 1998), which was focused exclusively on the role and structure of the board of directors in listed companies.
II. Specific topics.


Under Spanish Law, companies can only have a one-tier board. There is neither tradition nor any legal experience whatsoever regarding two-tier boards. Until recently, it was possible to argue that listed companies could have other arrangements for the administration of the company, such as having a sole director, or a number of directors acting jointly and severally. However, since the passing of the Financial Measures Act in 2002, that makes compulsory the existence of an audit committee in listed companies, it is implied that all listed companies must have a board.

The board in listed companies is a classic one-tier board. It is frequent that these boards delegate powers in one or several directors (CEOs), or in an executive committee. The executive committee, in particular, is widely used in companies where boards are too large to be operative. In this regard, the executive committee works as a sort of “mini-board” for the company.

The only committee that Spanish listed companies are under a legal obligation to have is the audit committee (s. 47, Act on Financial Measures, 22.11.2002). As a matter of fact, it is compulsory for all listed companies, and for all companies that are issuers of negotiable financial instruments, to have an audit committee. The audit committee must comply with the following rules: The committee must be formed by a majority of non-executive directors, and the President of the committee must be a non-executive director. The main characteristics of the committee must be set out in the company’s articles. The audit committee must have, at least, the following competences: 1. Reporting at the General meeting of shareholders related to the committee’s competences on all questions posed by shareholders; 2. Proposal to the board of directors and the General meeting of shareholders to appoint external auditors; 3. Supervising the internal audit of the company; 4. Knowledge of the process of preparation of financial information, and of the internal control systems of the company; 5. Relations with the external auditors, with the possibility of receiving information on any question that may jeopardize the auditors’ independence, and on any other questions related to the auditing process. Apart from these, the company’s articles may add other competences as well.

Corporate governance recommendations (the Olivencia and Aldama reports) also deal with committees of the board. Thus, it is recommended, on a “comply or explain” basis, that listed companies have a remuneration committee and a nominations committee. The possibility of merging the two committees into one is also recognised. In any case, it is understood that these committees must be composed of non-executive directors, with a substantial number of independent directors in them. The competences of these committees are self-evident.

The Aldama report includes a reference to a different committee, in which executive directors must be members, together with the other types of directors: the committee on strategy and investments. This committee is not exactly an executive committee: the committee on strategy
and investments is not supposed to deal with everyday matters, but, rather, to set the general strategy for the company and to make extraordinary investment decisions or acquisitions. The corporate governance report terms this committee as “voluntary”, which must be interpreted as being a recommendation with less emphasis.

Companies enjoy freedom to make the arrangements fit to their specific needs and features. However, it is compulsory for all listed companies to pass “board regulations”. These board regulations need to cover the internal functioning of the board, aiming at a better governance of the company (see s.115 of the Stock markets law – LMV, introduced in 2003). These regulations are sent to the Securities Commission (CNMV) and are also filed with the Companies’ Register. Their legal value is uncertain—it is difficult to affirm that a decision of a board adopted without complying with the board regulations is illegal, but it is also understood that board members that behave without due regard to the board regulations can be found in breach of their duty of care, or in breach of their duty of loyalty.

2. Role of non executive directors

The general principle is that executive and non-executive directors are subject to the same responsibility. In this respect, all directors share an identical regime. The Companies Act (LSA, last modified in 2003) establishes no differences: every director is subject to a duty of care and to a duty of diligence, and needs to be informed of the company’s affairs (s. 127 LSA).

The concept of non-executive director has not been legally defined. For that matter, not even the concept of executive director has been defined by the law. However, there is agreement, as expressed in the corporate governance recommendations, that executive directors are those that have delegated powers from the board, or those who have a contractual relationship with the company, apart from the directorship as such. The rest are non-executive directors.

There are different categories of non-executive directors in the corporate governance recommendations. The most important distinction is the one between independent directors and “proprietary” directors. “Proprietary” directors are those who have been appointed by a significant shareholder of the company. The recommendations on corporate governance recognize, in this way, the reality of a large number of Spanish listed companies, in which blockholders enjoy significant power. “Independent directors”, on the other hand, are prestigious professionals that must be independent from management and also independent from the main shareholders in the company. The corporate governance recommendations include a list of situations that prevent a director from being considered independent. Among these, the recommendations include: the existence of contractual relationships with the company, its management or with significant shareholders; being a director in a company that has appointed “proprietary” directors; or having family relationships with management or “proprietary” directors. Finally, the corporate governance recommendations also recognize the possibility that a non-executive director can be neither an independent director nor a “proprietary” director.
In any case, all directors share the same responsibility (s. 133 LSA).

3. **Executive remuneration**

Legally, directors’ remuneration should be established in the articles (s. 130 LSA), but this is interpreted to mean that the system of remuneration must be set in the articles, not the specific remuneration for directors. The only rule regarding the remuneration’s contents refers to the amount of remuneration where remuneration is fixed as a participation in the company’s profits. In this case, directors can only get their variable remuneration calculated over profits where, previously, at least a four per cent dividend has been distributed among shareholders (s. 130 LSA).

The other regulated remuneration is the remuneration based on stock options plans (since the reform introduced in the LSA in 1999). Any remuneration that is linked to the value of shares (stock options plans, share plans, or even variable cash remuneration based on the share price) has to be expressly recognized in the articles, and needs an express agreement by the company’s general meeting.

The Corporate governance reports recommend that directors’ remuneration be disclosed, at the very least, on a global and aggregate basis. The market is going a step further than the corporate governance commissions, and many companies are publishing the individual remuneration of each director.

4. **Financial responsibility**

All directors are responsible, in principle, for financial statements and financial information. The same rules for general responsibility apply (s. 133 LSA). Other information –individual disclosures of relevant facts- can also give rise to responsibility, although primary responsibility lies with the competent officers and executive directors.

Under Spanish law, company directors face a type of “wrongful trading” that is especially harsh (s. 262 LSA). Directors are personally liable, on a joint and several bases, for all the company liabilities, regardless of the date liabilities where contracted, in the cases where directors fail to take all necessary steps in the view of the company’s bad financial state.

The Aldama report recommends that the accounts should be certified by the company’s CEO and by the Chief financial officer. Of course, that “certification” is no substitute for the signing of the accounts by all members of the board of directors, who are collectively responsible for the accounts.
5. **Role of institutional investors**

The new Act on Collective Investment Schemes (LIIC, 4.11.2003) establishes that mutual fund managers, or other types of institutional investors must report on their voting policies and voting records in specific general meetings of shareholders. The Act even includes the possibility of establishing an obligation to vote at the general meeting of the companies where certain conditions apply (s. 46 LIIC). This rule needs, however, further legislative development. The latest news on the proposed regulations indicates that it is foreseen that institutional investors will have the obligation to vote their shares when they have at least one per cent of the company’s capital. If this is finally the regulatory approach, there will be very few instances in which collective investments schemes will be forced to vote their shares at the general meeting of shareholders.

6. **Regulation of audit.**

The regulation of audit in Spain was substantially reformed by the Act on Financial Measures (LMF) in 2002, and the changes in the law basically reflect the European Commission’s recommendation regarding auditor independence. Thus, the principle that auditors must “be and seem” independent is included in the legal regime of auditors.

Spanish auditors have always been under the control of an administrative authority (Instituto de Contabilidad y Auditoría de Cuentas, or ICAC), although the reforms in the law have increased the administrative control and sanctioning powers of ICAC.

The auditor independence regime is almost a translation of the European Commission’s Recommendation on the matter. Thus, the basic risks for the independence of auditors – advocacy, self-review, familiarity, and intimidation- are addressed with special rules. According to the law, auditors cannot hold managing positions in the audited company, or in companies related to the audited one. Auditors cannot have a financial interest in the audited company. Auditors cannot have family relationship with managers in the audited company. Auditors cannot prepare the accounts of the audit company, nor can design the information technology systems for the processing of financial information, although there is an exception where the audited company takes full responsibility for the internal control systems, or the services of information technology are provided in accordance with the audited company’s specifications and instructions. Independent auditors cannot perform appraisal or valuation services for the audited company. Independent auditors cannot render internal audit services to the audited companies, unless responsibility for the internal audit is taken by the audited company, under certain conditions. On another level, auditors cannot have significant commercial relationships with an audited company. Auditors cannot perform an “advocacy” role in the audited company, nor can participate in the selection process for executives in the audited company. Finally, in relation with consulting services being provided by audit firms, the law establishes that the audit partner cannot perform services for the audited company other than the audit itself. The audit firm can sell other
services to the audited company, provided that those services are not an unduly elevated percentage of the aggregate income received by the audit firm, considering the average of the last five years. It is submitted that these rules are not sufficiently strong to prevent the conflicts of interest derived from the rendering of services other than audit to companies.

Finally, there is a prohibition for auditors: in the three years following the audit, auditors cannot become directors, officers or workers in the audited company; nor can acquire a direct financial interest or an indirect significant financial interest.

As for auditor rotation, the law establishes a seven year period, after which the audit partner and all of his/her team must rotate. There is no rotation for audit firms.

It is important to underline the important relationship between auditing and the existence of a compulsory audit committee in listed companies (see above). The auditor must develop a relationship with the company’s audit committee. It is expressly foreseen that any matters related to auditor independence must be raised by the auditors to the audit committee, whose members are independent and supposedly free from pressure by management. It is also foreseen that auditors assist frequently at the audit committee sessions, in order to give information relating to the auditing process.

7. Corporate governance disclosure

The main vehicles for corporate governance disclosure are the annual corporate governance report, and the company’s web page. These instruments for corporate governance disclosure have been regulated by law, following the recommendations of the Winter report and the Aldama report.

All listed companies must publish annually a corporate governance report (s. 116 LMV, introduced in 2003). The annual corporate governance report must be communicated to the Securities Commission, and will be published as relevant information for the companies concerned.

The annual corporate governance report must offer a detailed explanation of the structure of governance of the company and its functioning in practice. Specifically, the annual corporate governance report must include:

a) The structure of ownership of the company, including information on substantial shareholdings, and familiar, commercial, contractual or corporate relationships between significant shareholders, and their presence in the board of directors. This paragraph also includes the shares held by members of the board of directors, the existence and contents of shareholder agreements that are known by the company, and, finally, the data related to
company’s own shares and dealings in the company’s own shares.

b) The structure of the board, including information on the members of the board, the rules of functioning of the board and of its committees, the remuneration of board members, their functions and positions within the company; their relationships with significant shareholders; the existence of members of the board who are also members of the board in other companies; and, finally, the procedures for selection, re-election and dismissal of board members.

c) Related party transactions, including operations with shareholders, directors, and companies belonging to the same corporate group.

d) Systems of risk control.

e) Functioning of the General meeting of shareholders, with information on the sessions and agreements of the General meeting.

f) The degree of compliance with corporate governance recommendations or, if the company does not comply with some of the recommendations, the explanation for the lack of compliance.

The contents of the annual corporate governance report have been specified further by a Ministerial Order and by a CNMV regulation. In particular, the CNMV regulation includes a form that companies must fill in and that covers all the relevant corporate governance information.

Companies are under a legal obligation to publish their annual corporate governance reports. If a company does not comply with this obligation, the CNMV could open a sanctioning file and impose administrative penalties on the company and their directors. Likewise, the contents of the annual corporate governance report must be correct and not misleading.

Apart from the annual corporate governance report, another important instrument for the transmission of corporate information to shareholders and to the investor public in general is the corporate web page. The corporate web page includes the annual corporate governance reports and a host of information that is useful for the shareholders, like the company’s articles of association, the documents for the General meeting, or the mechanisms for representation at the General meeting, among other aspects that are included in the CNMV regulation.

8. Codes as part of national law, enforcement, legal basis, etc.

A brief analysis of the corporate regulation developments in Spain shows that there is a trend towards more imperative rules and less space for self-regulation. This can be seen, in the Spanish
case, in the compulsory nature of the audit committee, the stricter rules for auditor independence, the obligation to publish the annual corporate governance report, and the obligation to have a corporate web page.

There are other aspects that are left for self-regulation, and corporate governance recommendations apply to these aspects. Corporate governance codes are recognized legally, given the fact that the law demands that the annual corporate governance report informs on the compliance or non-compliance of the company with respect to corporate governance recommendations. The problem in Spanish corporate governance is that nowadays there are two corporate governance reports (Olivencia -1998-, and Aldama -2003-), and the consolidation of the reports has not been made. To solve this problem, the Ministerial Order on the annual corporate governance report has charged the Securities Commission with the task of consolidating the two existing corporate governance codes into a single set of recommendations.

The Securities Commission is also the sole actor in corporate governance enforcement. Through the revision of corporate governance reports, or other *ad hoc* disclosures, the Securities Commission has the competence to enforce corporate governance rules. The enforcement exists at different levels: the Securities Commission can initiate administrative sanctioning files against those companies that do not publish their annual corporate governance reports, or that include false or misleading information in the reports. In the same way, the lack of a corporate web page, or lack of the required information in the web page can give rise to a sanctioning file. Apart from this, it is clear that the Securities Commission has the power to inquire companies on all aspects regarding corporate governance, and in particular on the explanations given for non-compliance with corporate governance recommendations. The Securities Commission has a very important instrument in its hands: the possibility of publishing any information regarding the compliance with corporate governance recommendations of a given company.
1. **Board Structure.**

There is no change in domestic law here except on non-executive directors (see below).

Final proposals have however been published for implementing the European Company Statute. The Government has abandoned the theory that GB law already allows 2-tier boards. Minor adjustments are proposed, for SEs only, to allow directors to be registered as executive or supervisory and to adjust substantive law - eg on disclosure, conflicts of interest - to fit the different capacities of management and supervisory directors\(^5\). Thus the UK will now have a special regime for SEs allowing the option of unitary or 2-tier boards, but will not take the opportunity to provide a similar option for domestic public companies.

2. **Role of non-executive directors.**

The Higgs revisions of the British Code on Corporate Governance were adopted with substantial amendments by the Financial Reporting Council in July 2003, coming into operation for years commencing after 1 November 2003.

The main changes on non-executive directors (NEDs) were as follows:

- Boards should consist of a majority of independent NEDs (IDs), but without removing a sufficiency of EDs to maintain balance.
- The Chairman should be independent on appointment but should not qualify as an ID thereafter.
- The Chairman should not be a former CEO or executive director. If this is done then there should be prior consultation with major shareholders and the case made to them.
- The Audit committee and remuneration committee should consist entirely of IDs.
- The nomination committee should consist in the majority of IDs. While it may be chaired by the chairman she should stand down when considering the appointment of her successor.
- A senior independent director (SID) should be appointed to provide an alternative channel to shareholders, to lead evaluation of the chairman and to chair annually meetings of the NEDs to evaluate his performance (substantially a separate board performance committee led by the SID).
- Directors cease in principle to be regarded as independent:

o if they have at any time in the past 5 years had employment or other material connections with the company
o if they have received remuneration other than directors fees (eg options, pension benefits)
o if they have family ties, cross-directorships, other links with EDs, or major shareholders, etc
o after 9 years’ service.

3. Executive Remuneration

The new Corporate Governance Code excludes directors’ remuneration regulation and disclosure, which is now since August 2002 a matter of substantive company law. This regulatory regime requires for all British companies listed in any EU or US exchange -

- Full audited disclosure of all remuneration paid in any form (including for example, pension benefits and benefits in kind or other perquisites) and severance payments by reference to individual identified directors.
- The presentation of a Remuneration Report to the shareholders at the annual general meeting for a mandatory advisory vote by shareholders.
- This report must state the policy on directors’ remuneration, with details of and justifications of performance links, including external comparators, or if there are no such performance links an explanation of why not.
- The Report must also contain a performance graph showing 5 years’ performance relative to a comparative index of similar companies with explanations and reasons for the comparator chosen.

The effect of this requirement is to force institutional investors to take a stand on controversial cases and to require a public debate of the two sides of the remuneration equation – amounts paid and the quality of operational performance achieved.

The overall effect has been to raise the quality of debate, to ensure that boards generally consult major shareholders in advance, to avoid AGM embarrassments and in most cases to ensure that shareholders achieve changes in advance where appropriate.

In my opinion this change has been a major reason for heightened levels of shareholder activism in the UK over recent months. As a result of this success the Government has abandoned proposals to regulate in detail the terms of company severance payments for directors (“rewards for failure”). Only one FTSE 100 company board (Glaxo, Smith, Klein – May 2003) and 2 other listed companies’ boards have suffered a defeat on their remuneration reports. The GSK defeat led to major changes in remuneration structure for the CEO and continuing debates on board structure. On two occasions I am aware that such discussions led to the removal of a chairman and on two others of a CEO.
The “comply or explain” code still however includes extensive principles and best practice norms on the levels of remuneration (including the desirable level of performance linking) and the process for settling policy and levels (through the remuneration committee setting ED remuneration and the GM or whole board setting NED remuneration).

4. Financial Responsibility

Responsibility for financial statements and the directors’ report (annual accounts) in the UK lies with the members of the board. There are criminal penalties for failure to provide to the AGM and publish at the companies registry annual accounts in due time and separate offences relating to their satisfying the relevant requirements as to form and content. Knowing or reckless failure on form and content leads to an unlimited fine. Failure to provide to the AGM or publish in due time also leads to a maximum £5000 fine plus a daily default fine (ie a penalty which increases by £50 per day until compliance). There is a defence for such failure that the directors took all reasonable steps to secure compliance.

There is also civil liability to the company for negligent or wilful failure to comply and perhaps to individual shareholders, but certainly not to the world at large. The liability to the company can be enforced by a derivative action (ie by shareholders on behalf of and at the expense of the company) in an appropriate case. The law on derivative actions is to be reformed in a major companies bill shortly implementing the Company Law Review. This will simplify, codify and somewhat extend the remedy. However the basic principle will remain that minority or individual shareholders should only be permitted to bring such actions where a failure in the governance system of the company has precluded proper collective decision making on the enforcement of the liability. (There is to be no automatic right for a minority to pursue actions on the company’s behalf).

There are much wider liabilities for fraud.

Auditors similarly owe a private law duty to the company and (definitely) to existing shareholders, but not more widely (unless on the basis of an independent contractual or undertaking based obligation), for their report.

Neither directors nor auditors are permitted to limit or indemnify their duties to the company at company expense. The Review proposed that auditors should be permitted contractually to limit their liability. The Government has now decided that a company shall be permitted to indemnify its directors in advance for litigation expenses in actions against them in their capacity as such (with the benefits to be reimbursed if they lose the action.) However it has decided at least for the time being not to provide for directors’ and auditors’ liabilities to be limited or capped or set proportionately to the degree of fault in multiparty cases. However it may introduce

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6 Section 233, 234.
7 Caparo Industries v Dickman [1990] AC 605 HL.
proportionate liability based on contractual agreements between auditors and the company ratified by the general meeting in next year’s legislation.

5. Role of Institutional Investors

Various recent reports and enquiries have proposed greater transparency in relation to the voting policies and performance of institutional investors, company reporting on the outcome of GM resolutions, a right of shareholders to have voting audited, and disclosure of major shareholders’ conflicts of interest (eg where they also manage the company’s pension fund or provide other financial services). The relevant professional bodies have put in place self-regulatory recommendations but the Government has indicated that legislation is likely.

6. Regulation of Audit

The Companies (Audit, Investigations and Community Enterprise) Bill, currently before Parliament, provides for extension and co-ordination of the regulation of auditors and auditing standards, greater disclosure of services provided by auditors and their related remuneration. It also implements the recommendations of the Review extending auditors’ rights of access to company books etc., and requiring directors to volunteer material information to auditors and all company employees to respond to their enquiries and requests for assistance.

The UK Government has indicated that it intends to adopt all the recommendations on the Commission Recommendation on Statutory Auditors’ Independence and the Auditing Practices Board (an arm of the statutory Financial Reporting Council) has consulted on implementing these provisions, with many detailed proposals on ethical and independence standards. The relevant standards are expected to be operative by September 2004.

The Financial Services Authority is reportedly considering requiring audit of at least the financial controls part of the corporate governance statement, and perhaps also of the “comply or explain” explanations. However conclusions on this await the outcome of the government’s consultations on the final form and audit of the OFR (see above).

7. Corporate Governance Disclosure

The regime on corporate governance disclosure remains unchanged – ie a comply or explain requirement sanctioned by the listing rules adopted by the Financial Services Authority under the Financial Services and Markets Act 2000, Part VI, with various civil and penal sanctions. However the proposed new mandatory annual Operating and Financial Review (OFR) may include such disclosure. This is a new annual report to be included with the annual accounts,

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covering the company’s current performance and prospects with indications of the company’s strategy and programmes in prescribed areas which the directors regard as necessary to enable a full appreciation. The Review proposed that this should include corporate governance information in addition to the Code compliance statement. However the Government is still consulting on this point.

It is hoped that the OFR will greatly increase the range of information available to shareholders and the markets thus facilitating effective corporate governance. The proper preparation of the OFR will be audited, but its content will be a matter for bona fide judgement of the directors, disciplined by the markets and ongoing experience.

8. Codes as part of national law – enforcement, legal basis etc.

See 7 above. The Review proposed that enforcement of the Code “Comply or explain” obligation should be transferred, together with OFR enforcement, to the Financial Reporting and Review Panel (the public law body, part of the Financial Reporting Council, charged with enforcing the accounting obligations of major and listed companies through specific enforcement orders). It is understood that the Government intends to do this, but there is no legislation as yet.

9 DTI Draft Regulations on the OFR May 2004.
Chapter 3 – Analysis

In the previous chapter we have given an overview of corporate governance developments in seven EU Member States. These examples show that corporate governance developments take place not only in corporate governance codes, but that in many Member States important legislative changes to company law have been made as well. In order to understand corporate governance developments in member states it is not enough to just look at the various codes that have been produced. What is actually included in a corporate governance code in a Member State to a very large extent depends on the contents of the company law legislation in that Member State. In order to understand where corporate governance developments in Europe are heading, we should not only focus on the various corporate governance codes that are introduced and amended, but also on changes in legislation. And what is indeed included in corporate governance codes often can only be understood properly if one relates also to the underlying company law legislation. What is included in codes and what in legislation is one of the key decisions to be taken in regulating corporate governance. We will make some general comments on this issue under 'Codes or legislation' below.

Common themes
The key areas where we see developments in corporate governance in Member States are the topics that we discussed in the national overviews in the previous chapter:

• board structure (one-tier and two-tier, committees)
• role of non-executive directors
• executive remuneration
• responsibility for financial reporting
• role of institutional investors
• regulation of audit
• corporate governance disclosure
• codes as part of national law

The fact that in Member States these themes are all addressed against a similar backdrop of corporate events in the US and in Europe is already creating some convergence of the regulatory developments in Member States.

Diversity is reflected
The developments we see in the Member States reflect the diversity of corporate governance systems in Member States. The diversity relates to a large extent to the differences in share ownership structures in Member States and the various ways that different company law mechanisms facilitate and regulate these structures. The traditional divide is between corporate governance systems based on dispersed share ownership and systems based on control exercised by major shareholders. Truly dispersed share ownership in the sense that there is no concentration of ownership at all, we hardly see in Europe. But there are different kinds of
concentrations of ownership, with different patterns of control exercised as a result. In Germany for example traditionally there has been a strong concentration of ownership in a small group of financial institutions such as banks and insurance companies, that jointly and in different coalitions own large stakes of German listed companies. There is a trend to dilution of these stakes, partly driven by the desire of these financial institutions to free their enormous investments which are practically locked up, and replacement with ownership by a larger group of (international) institutional investors such as pension funds and investment funds. In both Nordic and Southern European countries the prevailing concentration of ownership is family ownership, and different legal instruments are used to cement the control families can exercise (multiple voting rights, pyramid structures and cross-holdings). There is also an emerging trend towards dilution of these control structures and replacement with institutional investment but there is a stronger resistance to doing so on the side of the controlling shareholders. The process of dilution of control therefore is different from that in Germany. In all countries we see a trend to institutional ownership and some companies with large market capitalisations institutional ownership is prevailing. In the UK and the Netherlands institutional ownership is already prevailing across the market, and institutional investors are expected under the codes in these member states to play a role in the governance of companies they invest by making a considered use of their voting rights and disclose how they use these right. There is a trend here that the ownership of institutional investors is becoming a basis for new concentration of control itself, exercised by a small number of large institutions or by institutions organising themselves collectively in order to do corporate governance research and jointly exercise their rights. This is starting to raise new issues, for example on the governance of institutional investors (conflicts of interests, role of beneficiaries, competence and skills, role of intermediary institutions and their conflicts), which may trigger a new regulatory response. Indeed this has already led to demands for legislation and a defensive reaction by institutions in terms of a co-ordinated policy of more active intervention in the UK.

The effects of differences in ownership structures on corporate governance regulation is visible for example in the area of requirements for independence of non-executive directors. In the UK and the Netherlands such requirements are rather strict and focused on, mainly, ensuring the independence of non-executive/supervisory directors from the company itself and its management. Representatives of shareholders are not seen as independent. Employees and those representing them also are not seen as independent. In Germany, with its co-determined supervisory board, consisting for one third or half of employees or trade union representatives, and the shareholder appointed members usually closely linked to the financial institutions that jointly have control, neither the code nor legislation contains substantial independence requirements for supervisory board members. In Spain, where the prevailing system is based on controlling shareholders, a separate category of proprietary non-executive directors has been defined, who are appointed by significant shareholders of the company. In Denmark, where controlling shareholders are prevailing as well, independence requirements do not disqualify representatives of major shareholders. In France, directors representing major shareholders may be considered to be independent provided they do not take part in control of the company.
Internal and external audit procedures
The audit of companies’ financial reports is the subject of both legislation and regulation through codes in Member States. Requirements on the external auditor’s independence (non-audit services, rotation of partners and firm) are usually being laid down in legislation. This is probably related to the public function of auditors and a breach of trust in that function resulting from the corporate scandals we have seen in the US and in Europe. In corporate governance codes the focus is often on the role of the audit committee and the relationship between it, the executives, the internal audit function and the external auditor. We see a development in which non-executives communicate with the external auditor in parallel with the executives. The division of roles and the consequences this has in practice will have to be established and it may be a while before a new balance has settled. It also may be that different balances will result for different (types of) companies. For these reasons it is appropriate that these matters are dealt with in codes, with flexible enforcement on the basis of comply or explain. The extent to which the internal auditing function is addressed varies significantly. In the US one aspect of internal audit has received full, if not too much attention: the internal control procedures related to financial reporting. Internal audit and control appears to be an area where, to the extent regulation is required, inclusion in a corporate governance code and enforcement on the basis of comply or explain is appropriate. As companies differ substantially from one to another, in terms of size, risk profile, organisational complexity and regulatory requirements on their operations, so must the internal audit and control function within those companies. Apart from this, in the area of internal audit and control often more than one solution may be acceptable and appropriate. Best practice could, and arguably should, certainly be developed, but in a flexible regulatory environment.

Harmonisation, convergence and regulatory competition
As described above the mere fact that similar corporate governance issues are addressed by Member States in itself encourages the convergence of corporate governance regulation. Apparently these issues are generally seen as issues that need further regulatory development, without any particular harmonisation (at least formally) at the EU level. Key areas where actions are undertaken in all Member States include in particular the functioning of boards, its structure and committees, and executive remuneration. These are generally seen as areas where improvement must be made to ensure a restoration of confidence in listed companies. It is appropriate that the EU Commission seeks to ensure that all Member States consider these issues as it is doing through its Recommendations on strengthening the role of non-executive or supervisory directors and on fostering an appropriate regime for the remuneration of directors (adopted on October 6, 2004). The way that these issues are dealt with in Member States however are different, due to the different traditions and practices and legal structures in which they take place. It therefore makes sense that the EU does not impose EU rules on Member States through formal harmonisation, but through non-binding recommendations. The process of convergence in these areas needs to be a flexible one: it is more important that Member States develop their regulatory environment along similar lines than to have uniformity on the details.
We see little or no regulatory competition in the sense that there is not much competition for the incorporation of listed companies in the EU. This form of regulatory competition so far is more relevant for smaller companies and subsidiary companies. But Member States do compete with appropriate rules for their listed companies, and tend to wish to be seen to make improvements in order to offer an attractive capital market with appropriate regulation. This competition may lead to convergence of regulation in legislation and codes. It should be recognised that one of the advantages of such competition is innovation. That advantage will be lost if we insist on uniformity, or even regard convergence as an overriding objective. Whether or not this process will continue and lead to further convergence depends on to what extent it turns out that good corporate governance regulation through law or codes actually enhances the performance of companies and the value shareholders and society as such derive from them. A lot of research is undertaken to search for the link between performance and good corporate governance. The results are not yet conclusive, although there seems to be a general understanding that good corporate governance at least is a risk reducing factor. It is not yet established that this outweighs the costs of compliance with more stringent rules and codes, including the costs of inflexibility. This is another reason for not fixing corporate governance developments through mandatory harmonisation at EU level.

**Codes or legislation**

In the previous paragraphs we have already touched on the choice to be made between regulation of corporate governance through legislation or codes. The key differences between the two approaches are that (i) codes based on comply or explain by definition offer flexibility, while legislation tends to become mandatory quickly (although not necessarily), (ii) codes are produced by or at least with a strong influence of business and its shareholders and (iii) codes can be amended more quickly if needed than legislation, which requires a full parliamentary process. The choices made by member states will not always be the same but some general observations can be made.

- Legislation is appropriate to ensure that the essential legal infrastructure is available and operates efficiently. An area where this is relevant for example is the infrastructure required to allow shareholders of listed companies to use their voting rights efficiently through systems of proxy voting or voting by correspondence.
- Legislation is also appropriate to set generally accepted minimum standards to which all should at least adhere.
- Disclosure requires legislation and not a flexible approach. The regulatory objectives of disclosure (giving investors sufficient information to make investment decisions, enhance accountability of boards, enable shareholders to make considered use of their rights) can only be achieved if and to the extent disclosure is really made. Where it is decided that disclosure makes sense, companies should not be able to explain why they do not disclose certain information.
- Codes based on comply or explain are more appropriate where different solutions exist to achieve certain governance goals and companies require flexibility to adapt to their own
particular circumstances. The functioning and structuring of boards is a key area where this is relevant.

- Codes are also appropriate for issues where market practices need to be developed and where they may change in the foreseeable future or where consensus is not complete, or where practices may need to vary from sector to sector.
- Codes are also appropriate where the outcome of regulatory interference is yet uncertain. When in doubt, regulation through code should take priority over regulation through legislation.

**EU and Member State regulation**

There is not a natural balance between EU regulation of corporate governance and member state regulation. This will always be a political issue of which the outcome is to a small extent only predictable on the basis of regulatory arguments. Some observations can be made however:

- Harmonisation of company law at EU level should no longer be the single focus of the EU. As we have set out in our second report on A Modern Regulatory Framework for Company Law in Europe, the EU’s contribution should be to develop and implement company law mechanisms that enhance efficiency and competitiveness of business across the EU. Where this requires particular EU infrastructure (cross-border merger, cross-border voting by shareholders) regulation at EU level is justified.
- Otherwise, further convergence should only be imposed through harmonisation rather than being the result of Member States moving in similar directions, if the benefit of harmonisation at EU level is evident.
- One area where this may be the case is the applicability of corporate governance standards to cross-frontier situations. In some Member States corporate governance codes are part of the company law structure and apply to companies with registered offices in those Member States, regardless where their shares are listed. In other Member States corporate governance standards are part of the listing regulations and apply to companies listed in those Member States regardless of where their registered offices are. The result is overlapping (and sometimes conflicting) requirements for those companies who have multiple listings or have their listing in one Member State and their registered offices in another. Vacuums may also arise, e.g. for a company incorporated in a Member States that imposes a corporate governance code through its listing rules and listed in a Member State that imposed a corporate governance code as part of the company law structure. Similar problems arise with the enforcement of those standards or at least of the comply or explain practice. Solutions to overcome these problems must be developed at EU level.
- There is some pressure developing from the business community itself to develop explicit and clear EU corporate governance standards, both in order to avoid the confusing and conflicting application of various standards in Member States where they are incorporated and listed, as well as to have a stronger and more convincing European approach in
particular to be able to compete in regulatory terms against the American legalistic and enforcement driven approach.

EU Corporate Governance Forum
In our report A Modern Regulatory Framework for Company Law in Europe, we had recommended that the Commission set up a structure which facilitates the co-ordination of efforts of member states to improve corporate governance. The Commission is to up the EU Corporate Governance Forum to that end. The objective of the Forum is formulated to enhance the convergence of national codes of corporate governance and to provide strategic advice to the Commission, either at the Commission’s request or on its own initiative, on policy issues in the field of corporate governance. We note again that convergence should not be an overriding objective as such. It should be facilitated to the extent appropriate.

As we have set out in our second report, a key function of such a Forum should be to facilitate the co-ordination of the efforts of Member States to improve corporate governance. It should facilitate the exchange of views and experiences within Member States, both with respect to the contents of corporate governance regulation as well as to the process side of it (scope and applicability of codes, corporate governance disclosures, comply or explain, enforcement). The Forum could also operate as a think tank for the Commission when exploring the role of the EU in the development of corporate governance. To that end it could also organize consultations on particular issues.

Priorities for the Forum should be:

- to review the scope and applicability of corporate governance codes in the EU and to consider whether an EU approach is required in this respect
- to examine and keep under review the problems of cross frontier listing and cross frontier investment and the various needs of investors in different jurisdictions for corporate governance information and facilities for intervention
- to review the meaning of the different mechanisms of comply or explain in the Member States and the different regulatory instruments applied to enforce it.

The Forum should operate independently and in an open and transparent fashion, enabling all stakeholders to bring their views and experiences to bear in the development of best practice in the governance of the European corporate sector and the protection of investors in Europe.
Chapter 4 – Conclusions of the The Hague Conference

David Wright, Chair of the The Hague Conference, drew the following conclusions at the end of the conference.

1. Points of convergence

(i) That corporate governance is not a passing fad but a very crucial new subject for all companies; crucial for economic reform; crucial to restore confidence in capital markets; crucial for long term economic growth and investment. As one delegate described it, corporate governance “reduces the cost of disasters”. However, the economic evidence that companies that have higher corporate governance standards outperform the rest of the market is still fragmentary and it will be important that it becomes clearer in the future. In other words, that the cost of applying high corporate governance standards are outweighed by the benefits of a lower cost of capital, and a higher relative share price.

(ii) Unanimous agreement that a principles based approach to corporate governance is the right one for the EU compared to a detailed box ticking rules based approach.

(iii) The conference clearly showed that there is an underlying movement underway in all Member States to improve the level of corporate governance standards. Is convergence happening? It would seem that on paper it certainly is but we will have to wait to examine the practice and the implementation performances over the next few years.

(iv) Full agreement that whatever regulatory approach is decided, choice is important and flexibility to deal with different cultural approaches in the Member States to company law.

(v) Agreement that there must be a place for innovation and that the scope of corporate governance rules needs to be carefully considered vis-à-vis listed companies, SMEs – and the importance of encouraging venture capital.

(vi) The importance of implementation and enforcement was underlined by many speakers but questions were asked as to who should be the enforcers.
(vii) There was agreement that in an integrating European internal market care must be applied to avoid the imposition of multiple codes for companies that are active in many different markets.

(viii) There was widespread support for encouraging shareholder participation in board meetings and particularly encouraging cross border voting. This includes institutional investors fulfilling their responsibilities. Here a question was raised about the impact of hedge funds on share ownership because they are trading such large volumes on a very frequent basis.

(ix) Full support for rigorous transparency and disclosure requirements and stronger audit standards including strong coordination of European oversight bodies.

(x) Convergence on the need for Commission’s better regulation agenda to be fully applied in these areas.

(xi) Overall strong support for the Commission’s corporate governance and company law action plan and its mix of regulatory instruments. Most supported the recent Commission recommendations on non-executive directors and directors remuneration.

2. Points of divergence

(i) Some participants consider that corporate governance should concern not just the rights and roles of shareholders but all stakeholders. In other words, there should be a wider social dimension (corporate social responsibility) to corporate governance policy.

(ii) Some felt the “level of ambition of the Commission” was sub-optimal. The Commission had adopted a pick and choose approach and there had been a lack of a fundamental debate.

(iii) What type of regulatory approach is appropriate for corporate governance at the European level?

Here there were different views on the benefits of hard law versus self-regulation; market led versus public led initiatives; calibration and dosage of Commission proposals (linked to the subsidiarity and proportionality principles of the Treaties); regulatory competition - will this lead to a race to the top or to the bottom? On the question of whether a European code is desirable, the majority agreed with the Commission that this was not on the agenda.
although some felt it was a medium to long term inevitability. Some suggested linking the European Company Statute to the development of a European code.

On the question of “comply and explain”, there were different nuances about how this should be treated in legislative terms.

(iv) Some suggested that long term shareholders should be appropriately rewarded (e.g. higher voting rights).

(v) There were different views on the disclosure of remuneration and on the question of civil or criminal liability of directors.

3. External dimension

The external dimension was prominent in most of the discussions. There was agreement that this is a very crucial issue in global capital markets and agreement that we must avoid conflicts of law, double regulation, and excessive liability. But there were different views about how to manage the growing interfaces between the European rules and the United States rules. Do we:

- Converge principles to the maximum extent possible?
- Do we seek equivalence?
- Do we seek cooperative working models as Alex Schaub had designed to defuse the Sarbanes-Oxley impacts in the EU (cf. the 8th Company Law Directive)?

Some participants felt that market developments would help the convergence process – for example if European companies are dissuaded from listing in the United States etc due to, inter alia, fear of the implications of the Sarbanes Oxley Act.

Overall, participants agreed that if the European Union can find the right mix of policy instruments and incentives it has a real opportunity to not only construct a top class corporate governance framework in the European Union and in the Member States, but also to lead the world debate and to become a global reference for other countries.
Introduction by the Congress Chairman: David Wright, European Commission, Director Internal Market and Financial Services DG

Keynote Address: Frits Bolkestein, Member of the European Commission, in charge of the Internal Market, Taxation and Customs

Session 1 – National corporate governance codes: objectives and implementation
Moderated by Giselle van Cann, editor of Het Financieele Dagblad

Derek Higgs, Author of the Higgs report on corporate governance
Morris Tabaksblat, Chairman of the Dutch Corporate Governance Committee
Gerhard Cromme, Chairman of the German Corporate Governance Code Committee
Enrique de Aldama y Miñón, Chairman of the Spanish Corporate Governance Committee
Lutgart Van den Berghe, Member of the Belgian Corporate Governance Committee
Bertrand Collomb, Chairman of Association of Private French Enterprises and Association of Large French Enterprises

Session 2 – Consequences for policymakers
Moderated by Alexander Schaub, European Commission, Director General Internal Market

Gunnar Lund, Swedish Minister for International Economic Affairs and Financial Markets
Jan Willem Oosterwijk, Secretary-General Dutch Ministry of Economic Affairs
Ieke van den Burg, Member of Committee on Economic and Monetary Affairs of the European Parliament

Session 3 – Working with the national corporate governance codes in the EU
Moderated by Jane Fuller, editor of Financial Times

Alastair Ross Goobey, Chairman of the International Corporate Governance Network, chairman of the Hermes Focus Funds and senior advisor to and member of the European Advisory Board of Morgan Stanley
Bernd Stecher, Corporate Vice President Siemens AG
Bill Crist, Former Chairman of the California Public Employees’ Retirement System (CalPERS)
Claes Dahlbäck, Chairman of Investor AB and Member of the Swedish Corporate Governance Committee
Gert-Jan Kramer, Chairman of the Management Board of Fugro NV
Reiner Hoffmann, Deputy General Secretary European Trade Union Confederation

Keynote Address: Jacqui Smith, UK Minister of State for Industry and Regions

Session 4 - Comparison of the national corporate governance codes: is there any convergence?
Moderated by Jaap Winter, professor of international company law at the University of Amsterdam, Partner at De Brauw Blackstone Westbroek and chairman of the High Level Group of Company Law Experts

José Maria Garrido Garcia, General Counsel to the Comisión Nacional del Mercado de Valores, and professor at the University of Castilla-La Mancha
Klaus Hopt, Director Max Planck Institute, Hamburg
Jonathan Rickford, Director, The Company Law Centre, British Institute of International and Comparative Law
Jan Schans Christensen, Professor at the University of Copenhagen
Joëlle Simon, Legal Affairs Director, French Business Confederation MEDEF

Keynote Address: Gerrit Zalm, Finance Minister of the Netherlands

Closing remarks by the Congress Chairman: David Wright, European Commission, Director Internal Market and Financial Services DG
Corporate Governance in the European Union

It is an honour and a particular personal pleasure for me to deliver the opening speech at this conference organised by the Presidency. This is the first time that a Presidency of the European Union has organised such a high level gathering of distinguished experts in corporate governance to exchange views on how to promote sound corporate governance practices across the European Union. The Presidency, and in particular the Ministry of Finance, deserve our congratulations for their initiative. I hope it will not be the last.

This conference is timely. It takes place at a moment when the European Commission has just taken the first measures to implement the EU’s Action Plan on Company Law and Corporate Governance. In so doing, the Commission has been praised but it has also been criticised by the business community, perhaps because there are some misunderstandings of the intentions of the Commission. Dialogue between regulators, issuers, investors and all interested parties is an essential precondition for mutual understanding. So I hope I will be able to slay some of the dragons today.

1. The economic importance of corporate governance

Corporate governance is now high on the European political agenda. This is not just a response to the wave of scandals in the US and in Europe. It is due first and foremost to the fact that businesses which have sound corporate governance practices perform better and are valued more highly. Good corporate governance is an essential prerequisite for the integrity and credibility of our financial institutions, stock exchanges and individual corporations, indeed of our capital markets in their entirety.

Corporate governance is not an end in itself. Its aim is to promote the long-term success of companies and economic growth. Asking shareholders to support companies that take risks and embark on projects with only long-term payoffs requires trust. Good corporate governance helps to create this trust.

We have to pose ourselves a simple question. Is it not the well run, diligent, transparent, productive companies – sensitive to the concerns of their shareholders – which act ethically and environmentally, which will survive in the long term? Without doubt, the answer is yes. Those with a short-term view, which engage in cowboy-like activities and are untransparent: they won’t survive. The list of victims is long. Many have suffered as a result of their activities.

In today’s integrated markets, failure to deal with the regulatory issues associated with corporate governance will have repercussions on global financial markets and jeopardize financial stability.
That is why responsible policy makers at all levels cannot ignore the issue and why the European Union, and the European Commission must not.

2. The Role of the EU – Fostering greater convergence

These concerns, the corporate scandals, have triggered discussions in the EU and in other parts of the world. As a result of them, the Commission is now promoting the development of a sound corporate governance framework at the level of the European Union.

We have, of course, taken account of the great diversity of corporate governance practices and systems within the EU. This is why we proposed a balance of binding and non-binding measures in the Action Plan. But with a clear objective: to promote greater convergence within the European Union towards best corporate governance practice. The dosage and calibration of activity at EU level has been carefully thought out – respecting the subsidiarity and proportionality principles of the Treaty and attentive to different national cultures and approaches.

The two recommendations

The two Commission recommendations on directors’ remuneration and on the role of non-executive and supervisory directors, which were adopted recently, are aimed at meeting this objective. These recommendations were based on a thorough assessment of the situation at national level and of the efforts in a number of Member States to improve their corporate governance framework. They have been subject to extensive consultation of all interested parties. The Commission has taken due account of the, sometimes contradictory, comments received from issuers and investors.

Both recommendations aim at improving the integrity and accountability of companies’ boards. We believe non-executive and supervisory directors have a duty to fill the gap between uninformed shareholders and fully informed executive managers, by making executives more accountable. Special attention needs to be paid to the role, quality and integrity of non-executive directors.

Board members must be truly accountable to the owners of the company. Shareholders need to be able to ensure that management pursues their interests. They own the company. Not managers. Shareholders must therefore be given the means to act as watchdogs, to protect their interests as well as those of the other stakeholders. This is particularly the case in areas where there are conflicts of interest such as in remuneration matters. The Commission has recommended that Member States should ensure a high level of transparency for directors’ remuneration and encourage shareholders to make their voice heard on the remuneration policy of the company and on remuneration items which are closely linked to the share price.
Another means to foster convergence of corporate governance systems and practice is to encourage an exchange of information and best practice in the Member States. That is why the Commission’s has decided to set up a “European Corporate Governance Forum” to co-incide with this Conference today. This Forum, which should meet for the first time before the end of the year, will be composed of 15 outstanding high-level experts in corporate governance – many of whom are present at today’s conference. We have sought to ensure a balanced representation of all those having an interest in sound corporate governance practices: investors, issuers, regulators, worker representatives and academics. A spokesperson will be appointed from amongst the forum’s members.

Fears have been expressed about the Forum playing a regulatory role. Some allege it will secretly design a fully-fledged European corporate governance code. I want to reassure you: this is not the Commission’s intention. The objective of gathering a small group of very knowledgeable people is to help the convergence of national efforts, encourage best practice and advise the Commission. It will however not provide advice or expertise on legislative initiatives. We will, of course, ensure transparency in the operation of the Forum.

Transatlantic convergence

Capital markets, economies and businesses are interconnected and global. What we do will affect, for example, the US and vice versa. This makes it essential to ensure effective cooperation with our main trading partners, in particular with the United States. Yet the approaches followed on both side sides of the Atlantic are quite different. The European approach is essentially based on a principle and “comply or explain” basis. The US approach is rule-based and relies more on law enforcement.

What is important is that on both side of the Atlantic, we aim for the same basic goals. Wherever possible, we should aim to converge our thinking, before laws are made. If we don’t do this, if we don’t make these efforts, friction will arise; and we will be faced with downstream regulatory repair. And we know how difficult this is – on both sides of the Atlantic.

I believe that, for example, ultimately the EU and US will have to cooperate on recognising the broad equivalence of their own accounting rules – the IAS and US GAAP. We are all encouraged by the cooperation between the FASB and IASB. But much more progress is needed over the coming months.
4. Regulatory Initiatives

Shareholders’ rights

There are, however, cases where convergence may not be enough, especially when greater integration of our capital markets is hindered by the persistence of deeply-rooted legal obstacles which justify regulatory initiatives.

This is notably the case when it comes to facilitating the exercise of certain basic rights by shareholders, in particular voting rights. In cross-border situations, difficulties arise from the presence of a chain of securities intermediaries between the issuer and the ultimate investor who has an economic interest in the shares. In mid-September, the European Commission launched a public consultation addressing this issue and is seeking views on the design of a framework defining intermediaries’ obligations and investors’ rights. This should help us in our efforts to prepare a proposal for a directive aiming to facilitate the exercise of basic shareholders’ rights throughout the EU by the end of next year.

In order to allow shareholders to exercise greater control, they should first be better informed about their rights and the company’s corporate governance practices. This is one of the reasons why the Commission intends to propose that all listed companies should be required to include in their annual documents a coherent and descriptive statement covering the key elements of their corporate governance structures and practices. They should indicate what code they follow on a “comply or explain” basis. They should also disclose complete information with regard to group’s structure and intra-group relations, including the listing of all Special Purpose Vehicles and other offshore structures. The Commission intends to adopt a proposal in this respect very soon.

Clear and transparent information needs to be accompanied by effective external control mechanisms. The independent audit of a company and the required disclosure to the supervisory bodies constitute the backbone of an effective financial market regulation. Concerns have been expressed about whether the incentives for external auditors are properly aligned with the interests of the shareholders. Urgent action was required to restore the credibility of external audits. This led the European Commission to adopt the proposal for a Directive to modernise Statutory Audit within the European Union. This proposal introduces new requirements concerning the manner in which an audit should be carried out and the structures needed to ensure audit quality and trust in the audit function.

One important issue in relation to corporate governance is the requirement for an audit committee for public interest entities – this is not popular with some Member States. But I strongly believe that audit committees are crucial for ensuring audit quality and to keep a healthy distance between the auditor and management.
I am confident that the efficient work of the Irish and Dutch presidencies will lead to political agreement around mid November. This could open the door to the prospect of its adoption in one reading by summer 2005.

5. Conclusion

To conclude:- “Is there a clear role for the EU in this process?”

I am convinced the answer is yes. EU action on corporate governance and company law is fully justified as part of the EU economic reform agenda. This action must be measured and proportionate in order to ensure financial stability and market confidence. Corporate governance systems within the EU must all move towards higher standards. Shareholders must exercise their rights across EU borders.

We have a lot to learn from each other. This is why the Corporate Governance Forum the Commission is setting up and the Conference today are important. Corporate governance is not an optional bolt-on. It is part of modern economics and business practice. Our challenge is to lead the debate in the European Union, and beyond and to adopt the right policy approach to the different issues. I am sure your discussions today will help meet this objective.

Ladies and Gentlemen, thank you for your attention.
Empowering the EU Markets

I’m really pleased to have the opportunity to speak to this conference today. Corporate governance is important in its own right. But the issues at the heart of this conference – finding the balance between EU and national action and the balance between legislation and flexibility – go to the heart of the challenges we face in developing a Union of 25 Member States.

My view is that this is an area where suitably targeted EU action can make a difference but where we should predominantly operate through national codes. I will explain why I take the view. But we need to consider first what corporate governance standards are for. The simple answer is to protect shareholders and creditors. But I believe that is too narrow a view. Indeed, it can be dangerous, leading to the wrong type of regulation, imposing burdens on companies and restricting the economic activity upon which we all rely.

The real purpose of corporate governance is to encourage and enable companies to create the internal structures and controls that will promote trust and lead to better performance. We all know what happens when things go wrong and trust is lost – people lose their jobs, their investments, their pensions.

But when standards are high, confidence in our companies attracts investment, and creates the foundation for enterprise, innovation, competitiveness and employment. Effective Boards allow companies to manage risk and improve performance, leading to better returns for shareholders.

For these reasons, I see corporate governance as squarely within the aims of the Lisbon agenda for economic reform. The test for action at EU level is whether it furthers that agenda; whether it will help to increase investment; improve business performance and competitiveness; and generate the innovation and growth on which future jobs and pensions depend.

In the UK, we ask ourselves three questions when considering new proposals for corporate governance or company law.

- Will change promote enterprise, investment and the free flow of capital in support of growth and innovation?
- Will change maintain the right balance between oversight by shareholders and the directors’ ability to drive the business?
- Will we enable the market to reward strong performers and punish those who do not serve investors’ interests, or will the regulatory authorities become, de facto, the judges of performance?

Our clear goal is to ensure that enterprise continues to flourish, that the capital markets remain effective, and that people have trust and confidence in business. We see the role of the state as being to enable the market – and more particularly shareholders - to judge performance, not
stand in its place. Giving shareholders the opportunity, and the means, to make their own judgements and hold management to account is at the heart of our approach.

This is a rather more ambitious set of objectives than that of “protection of shareholders and creditors”. Indeed, talk of “protection” implies that those who own companies and those who run them are on opposite sides. But the UK institutional investors who own, on behalf of their clients, the large majority of shares will tell you that they rather like companies. Companies provide the returns upon which investors rely. And companies need investment from shareholders who are committed in the long-term - shareholders who are prepared to work with them to improve performance. So, the practice in the UK has been to work not in opposition, but in partnership.

It is through partnership that the UK Combined Code on corporate governance has been created. The Code was developed in the course of the 1990s by a series of committees set up by market participants, chaired by leading company directors, and with membership drawn from companies, investors and their advisors. As market practices and expectations have changed, companies and investors have recognised the need to raise standards, and have worked together to do so.

The process is evolution of standards, not incremental regulation. To maintain that evolution, we have now set up a mechanism for continuing development and monitoring of corporate governance standards through our Financial Reporting Council – an authority that is publicly accountable but grounded in the market. The Council and its Corporate Governance Committee include leading figures from business, the investment community and their professional advisors. Its decisions are made by people who intimately understand the markets. And, in explaining those decisions, it has a head start in securing a market response because many of the markets’ and professions’ leading figures are involved by the Council at all stages, they own its conclusions and want to make them work.

The key underpinning of the Code is that companies either comply with its provisions or they explain why not – explain not to a regulator but to the shareholders. By this means, we have enabled the market, not the state, to judge the actions of a business in the light of the specific circumstances of that business. A code is working when people give good explanations just as much as when they comply with normal requirements. Legislation doesn’t have that capacity. It is too inflexible – incapable of recognising the varying needs of companies, incapable of providing for different investment strategies, and incapable of reacting quickly to changes in the market.

I have explained how we do things in the UK. Other Member States have different cultures, economic conditions and company law structures. This has led them to pursue diverse yet equally valid approaches to corporate governance. But one thing we share in common. We have all developed or are developing corporate governance regimes fit for the modern market, together with mechanisms to ensure those regimes remain up-to-date.

What can action at EU level add to this, while respecting our differing frameworks?
The answer is that EU action can contribute to the Lisbon goals of promoting growth and employment by tackling failures in the market created by cross-border problems. I believe that there are five types of action that may improve the operation of our markets.

- Action to enhance financial stability and market confidence. It is clear from recent scandals that a failure in one national market can reach across borders and threaten all markets. We each have an interest in knowing that our EU partners have high standards.
- Action to extend investment opportunities across borders. Investors should be able to have confidence in the corporate governance regimes of all EU markets, and they must be able to exercise their shareholder rights regardless of nationality.
- Action to remove barriers to the efficient operation of markets, improving access to capital for companies. Companies should not face regulatory barriers or a multiplicity of widely different corporate governance regimes when they want to raise capital on the EU markets.
- Action to make it easier for companies to set up cross-border operations. The costs of setting-up, restructuring and winding-up businesses that operate in a number of Member States must be kept to a minimum.
- Action to create the trust in our companies and markets that will attract international investment and those seeking capital from around the world. We must be open and outward-looking, recognising that we operate in a global marketplace.

I believe that the Commission’s Action Plan provides the right platform to meet these objectives. The challenge for all of us is to develop the Action Plan to promote convergence through partnership and dialogue among market participants at EU level.

I believe the Commission has made an excellent start, using alternatives to legislation such as Recommendations to create a balanced approach. Because we all have different company law frameworks, the non-regulatory principle is even more important at EU level than it is at national level. The UK will support legislation where it is the only way to meet our objectives, but our natural inclination is to use other methods if they can deliver.

We all know that one size does not fit all companies. Very often, one size does not fit all Member States.

And when we do have to make legislation, it must comply with the EU’s better regulation principles. It is essential that the Commission’s Better Regulation Action Plan and the four Presidencies’ Joint Regulatory Reform Initiative feed down into improved consultation and impact assessments on all company law proposals. There must be sound evidence that legislation will not impose excessive burdens, while helping business to prosper.

I am pleased that the Commission is determined to improve its consultations and impact assessments, and I welcome its commitment to sharpening the focus on competitiveness in these. The development of the company law Action Plan through extensive consultation by the High-Level Group was an example of best practice.
But there is still much to be done. I recently saw an impact assessment for a company law proposal that recommended the retention of regulation because it protected shareholders and creditors. No further evidence or argument was given. It will be clear by now that I do not believe this is enough. I want to see assessments that provide clear evidence that one or more of the five reasons I have given for EU cross-border action have been met, and that, as a result, enterprise and competitiveness will improve.

If we do these things, the Action Plan will encourage the development of national regimes within a flexible common framework.

It is for this reason that I warmly welcome the launch today by the Commission of the Corporate Governance Forum. The Forum is designed to promote corporate governance through dialogue, partnership and best practice implemented through national codes. I believe that the Forum will flourish and gain the respect of our national markets if it develops into a strong, independent voice of the EU market. I hope that it will work closely with EU and national authorities and regulators, but not be their servant. It is the key alternative to legislation in the Action Plan, and it is in all our interests to make it work.

The UK will play its part in ensuring that the Action Plan is a living document, taking account of changing economic priorities and changing market practices. We are exploring the possibility of holding a follow-up to this conference during our Presidency. And under our Presidency we will do our best to ensure swift progress on company law proposals before the Council, highlighting the need to promote competitiveness, meet the better regulation agenda, and respect the different cultures of the Member States.

I applaud this conference and the Action Plan as an opportunity for a new way of working together. A way that uses alternatives to legislation, and is based on openness and trust between Member States and between companies and their investors. A way that works with the grain of the market, allowing EU companies to compete on a global stage. A way that will ensure high standards of corporate governance leading to more prosperity for us all.
Corporate Governance in the European Union: convergence instead of harmonisation

1. Opening remarks

Ladies and gentlemen,

As your host today, I am extremely pleased to see so many people from so many countries and a diversity of backgrounds attending this European Corporate Governance Conference. A clear proof that corporate governance has left the domain of European and national statute-books, and has become a daily reality. Creating high standards of corporate governance is one of the priorities of the Dutch Government. Also as President of the European Union, the Netherlands has no monopoly on corporate scandals. Nearly all Member States are in the process of adjusting and strengthening their corporate governance legislation. Industry and investors’ representatives are working together; creating corporate governance codes or changing existing ones.

Today’s speakers have explained a lot is going on at the moment in Europe and elsewhere. I am thankful for their openness to share their thoughts with us. The momentum is right to analyse the state of play on corporate governance in Europe. To look back on our achievements so far; to see to it that we are still on the right track; and to assess the possible need for new initiatives. To mention a few: should we leave more room for self-regulation? And if regulation is needed, do we need more national or European legislation? All these items were discussed today and we now have a better understanding of what has been achieved and what still remains to be done. I sincerely hope the Conference today has provided a spring-board for further work on corporate governance. In this respect, I congratulate Commissioner Frits Bolkestein with the launch of the European Corporate Governance Forum. For the sake of coherent policy making, it is crucial to have corporate governance developments in the European Union monitored by this High Level Group of Experts, exchanging best practices and national experiences. I will come back to this topic later in my presentation.

First, I would like to recall the general economic importance of good corporate governance. Then, I will turn to some of the actual problems in the corporate governance structures. In an integrating European market, we are, after all, facing more and more identical problems. I will also look at the different approaches used by Member States trying to solve these problems and assess whether the European legislator has a role to play.

2. Why is corporate governance important?

But first: what makes corporate governance so important? Good corporate governance ensures transparency, fairness and accountability, towards shareholders and other stakeholders. It is a prerequisite for integrity and credibility of companies. By building confidence and trust, good
corporate governance allows access to external finance. It allows companies to make credible commitments to creditors, employees and others. In short: good corporate governance lowers the internal risk, thus lowers the costs of capital, while improving financial stability. Good corporate governance is therefore beneficial for the companies themselves, as they can attract new capital more easily.

These effects stimulate economic growth. We can achieve economies of scope and scale, undertake more risky and distant ventures, engage in projects with more long-term payoffs, and employ innovative work and organisational structures. These objectives all require the institutional certainty and confidence that only good corporate governance is able to provide.

If Europe as a whole could develop high standards of corporate governance, Europe will be better equipped to compete for capital on global markets. By strengthening our present corporate governance, Europe will set a step forward in terms of the ambitious Lisbon Agenda, which aims to make the European economy more competitive.

3. Characteristics of the problems in our corporate governance systems
But we are still far away from this goal. Confidence of investors and the public at large in companies was badly shaken over the last few years. We all heard about the corporate scandals, where both sides of the Atlantic have provided input: Enron, WorldCom, Ahold, Parmalat. These high profile cases of governance failures were not limited to a specific industry, market, product or country. Although they took place within different corporate governance systems, they have one important element in common: checks and balances were ignored or failed to work. The Supervisory Board in a two-tier system and the non-executives in a one-tier system were unable to stand up to the Management Board or executives, who could do whatever they liked to do with the money of investors.

This problem is, however, not new. Adam Smith\(^{10}\) noted in 1776 already that, and I quote: “The directors of public companies being the managers rather of other people’s money than of their own, cannot well be expected that they should watch over it [meaning: the money] with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company”.

The separation of ownership and entrepreneurial control is a central feature of modern capitalism, implying a specific interaction between the creator of a business idea and the investor with the necessary capital to enable conversion of that idea into reality. This is a universal feature for listed companies and is independent from a corporate governance model chosen in a country.

\(^{10}\) Adam Smith (1776), *Inquiry into the Nature and Cause of the Wealth of Nations.*
4. Approach to tackle the problems

Various checks and balances exist inside and outside a company to minimise the risks associated with conflicts of interest between the management and the stakeholders. These are exercised by so-called “company watchdogs”, like Supervisory Boards and the shareholders meeting. European policy makers and national corporate governance committees are looking for governance tools, incentive structures and regulatory mechanisms to strengthen the position of these watchdogs. They focus on improving and facilitating shareholder rights, increasing disclosure and transparency, strengthening the independent position of the external auditor and strengthening the independence and functioning of the Supervisory Board or non-executives. These policy actions have led to a convergence in practices. For example, we see a tendency to create more independent subcommittees of boards in “one tier systems”, while at the same time we see more direct involvement in the management decisions by Supervisory Boards in “two tier systems”. The two tier and one tier board structures have converged and now share common features.

However, while we see convergence of approaches to tackle the problems related to corporate governance, we do not see fundamental changes in the corporate governance models of the Member States yet. For example, the system of “co-determination” – the participation of employees in company’s management – still exists in Germany, although pressure from investors is growing. In my own country, the mandatory application of the two-tier board system for some large companies, also known as “structuurregime”, was adjusted recently in order to increase the powers of shareholders. However, the “structuurregime” was not abolished; so far it has survived attacks from the international investment community. Moreover, Supervisory Boards in the Netherlands are legally obliged to exercise their supervision in the best interest of the company and its businesses. They have to take into account the relevant interests of company’s stakeholders. In the UK, however, the Board has to act only in the interest of the shareholders. And in contrast to the situation in the UK, most continental Member States want to maintain the ability for their companies to raise anti-takeover measures being confronted with a hostile takeover. The experience with the Takeover Bids Directive is illustrative in this respect.

With these fundamental differences in corporate governance models in the Member States, simply harmonising EU corporate governance legislation is neither feasible nor desirable. In principle, regulators should regulate the market, not define it. Markets should be allowed flexibility to organise themselves most effectively and be most competitive. The regulators should define the boundaries within which the market can explore these freedoms and supervisors must see to it that the rules are complied with.

However, day-to-day reality is sometimes more complicated. Indeed, we can see that corporate governance models are deeply embedded in the country’s tradition, history, and culture, and will therefore change very slowly. At the same time, however, the social outcry for corporate governance legislation is becoming louder. This has to do with the corporate scandals with cross-
border implications, the legalistic approach by the United States via the Sarbanes-Oxley Act and
the crumbling of common values and conventions. How to overcome this paradox?

5. Corporate governance regulation and corporate governance codes
To answer this question, it is important to outline the playground. Corporate structures are
changing, financial innovation is taking place with the speed of lightning and the process of
globalisation is unstoppable. Legislation can simply not keep up with the speed of these market
developments. However, as we have seen, there is a clear call for benchmarks for rules of
behaviour. Corporate governance codes are a suitable instrument for this, in addition to a strong
legislative national corporate governance framework. The big advantage of codes, compared to
legislation, is that the process is much faster. And speed is essential, because – as we have all
noticed – opinions and views about ‘good’ corporate governance are changing rapidly. So we
must be able to respond to the pace of change. Therefore, a code will be more flexible and
‘progressive’ than the less flexible instrument of detailed regulation - particularly in the constantly
changing entrepreneurial and financial landscape. Moreover, as the key input for corporate
governance codes comes from the market participants, it stimulates market participants to take
responsibility by themselves in drafting good corporate governance principles. It will also
increase their commitment to apply these codes rigorously. But as we saw in the Netherlands
over the last decade, a self-regulatory market approach, based only on non-binding
recommendations of a Corporate Governance Committee is clearly not sufficient. Listed
companies should at least have the statutory obligation to explain whether, and – if so – why, and
to what extent, they do not comply with the corporate governance code. Listed companies may
depart from the code, true, because companies are different and corporate governance should be
tailor-made and thus allow flexibility. However, the company should disclose the reasons for a
possible deviation. By having such information about the corporate governance structure of the
company, investors can decide for themselves to invest or not to invest in that company – and
adjust the conditions if needed.

Having said this, you should not be surprised that I fully support the approach of the European
Commission in the EU Action Plan on Corporate Governance. The Commission’s mantra is to
legislate only where this is necessary. For instance, European legislation has been announced – or
is already on its way – to tackle the problems relating to cross-border voting by shareholders and
to facilitate cross-border restructuring and mobility of companies. These are very important
initiatives in getting rid of some of the most prominent barriers in this area. Other corporate
governance problems should be tackled at the national level. At a national level it is important to
make a balanced choice of what should be regulated by law and what can be left to self-regulation
by codes. So-called essentials: high risk and high impact matters should be regulated by law.
Matters that relate to the balance of power within the company: matters where a corporate
governance code is too weak an instrument and therefore not suitable – as directors don’t give up
power voluntarily. Examples are: fundamental rights for shareholders to “correct” failing board
members, the protection of minority shareholders and the use of anti-takeover measures in
hostile takeover situations. Remaining issues, the rules of behaviour for Management Board Members and Supervisory Board Members, can be regulated by national codes.

However, where does this lead us to? After Member States have developed their official corporate governance code, we end up with 25 different corporate governance codes in Europe. I personally think market forces will automatically lead to some kind of convergence of best corporate governance practices, which is already emerging. This is a very important European reflex.

From this perspective, I welcome the launch, today, of the European Corporate Governance Forum. This Forum can promote the convergence of corporate governance practices further, by monitoring the operation of national codes and exchanging best practices in the Member States. By that, we learn from each other’s experiences. This bottom-up approach of convergence is, in my opinion, much more effective in developing high standards of corporate governance in the EU than the possible alternative: a top-down approach of increased harmonisation or unification.

Before I will end my speech, I would like to mention some topics that will become important in the near future for the national corporate governance committees and the European Corporate Governance Forum. I think that we will witness a shift of emphasis in the codes from rules of behaviour for board members to rules of behaviour for shareholders, especially large institutional investors, like pension funds and mutual funds. Public pressure mounts that these funds participate at shareholders’ meetings and are transparent about their voting policy. Moreover, the internal governance of these funds is now a topic for discussion. As these large investors are increasingly participating in the decision making at shareholders’ meetings, it is also important that the agencies that advise these large investors are really independent and are transparent about their operations.

Concluding remarks
I will now come to my conclusion. The EU Member States face the same problems with regard to corporate governance and the checks and balances in companies. We share the same objectives: restoring public confidence and preventing corporate failures from occurring. We are doing that by strengthening the checks and balances in companies by increasing transparency and accountability. This is, however, taking place within different corporate governance models. I do not think that one system or model is better than the other. Most important is that we should engage in a constructive and permanent dialogue in order to achieve a full understanding of each others methods and practices. And that was exactly the intention of this Conference!

Thank you for your attention.
Annex E – Members of the European Corporate Governance Forum

- Antonio Borges (PT), Vice Chairman of Goldman Sachs International and board member for several corporations

- Igor Adam Chalupec (PL), President of the Management Board and CEO of PKN Orlen (energy company)

- Bertrand Collomb (FR), Chairman of Lafarge and of ‘Association Française des Entreprises Privées’ (AFEP)

- Gerhard Cromme (DE), Chairman of the Supervisory Board of ThyssenKrupp, President of the German Corporate Governance Code Commission

- David Devlin (IE), Partner PwC, Chairman of the ‘Fédération des experts comptables européens’ (FEE)

- Emílio Gabaglio (IT), Former General Secretary of the European Trade Union Confederation

- Jose Maria Garrido Garcia (ES), Head of Legal Service and Secretary to the Governing Council, CNMV (Spanish securities and exchange commission)

- Peter Montagnon (UK), Head of Investment Affairs, Association of British Insurers

- Colette Neuville (FR), Chairman of ADAM (Association de défense des actionnaires minoritaires)

- Roland Oetker (DE), Chairman of DSW (German Association of private investors)

- Alastair Ross Goobey (UK), Chairman of ICGN and of Hermes Focus Asset Management Ltd

- Rolf Skog (SE), University of Stockholm

- Andreas Trink (EE), Chairman of the Management Board of the Estonian Financial Supervision Authority

- Jaap Winter (NL), University of Amsterdam

- Eddy Wymeersch (BE), Chairman of CBFA (Belgian SEC) and member of the Committee of European Securities Regulators (CESR)