

## **SECOND EUROPEAN CORPORATE GOVERNANCE CONFERENCE**

**Luxembourg, 28 June 2005**

### **PERSPECTIVE: THE EUROPEAN CORPORATE GOVERNANCE FORUM**

#### **INTRODUCTION**

I have been invited to report briefly on the work of the European Corporate Governance Forum appointed last year by the European Commission.

In order to do so I should like to briefly mention the background so as to explain the role of the Forum and tell you a little bit about how we operate so far.

It will also be helpful to refer to the expert report on European Corporate Governance prepared for the first conference held in The Hague last year.

The main part of my remarks will be devoted to our current agenda when I will discuss the priority subjects which are being addressed by the Forum.

#### **BACKGROUND**

As with many other aspects of reforms of the Internal Market, the European Commission started preparation in the field of corporate governance quite some time ago. In a far seeing move, a high level group of experts led by Jaap Winter was appointed to examine the whole topic of company law and corporate governance in the EU and how the Commission might shape policy for the years ahead. The so called Winter Report was issued in 2002 and was the subject of consultation by the European Commission. In turn, this led to the important Commission Action Plan, published on 21 May 2003 "Modernising Company Law and Enhancing Corporate Governance in the European Union – a plan to move forward". Six months later the Commission published a synthesis of the responses it had received to the communication in a most helpful working document.

It is worth referring to the responses received in relation to the scope of the EU action. In order to foster efficiency, the competitiveness of business and strengthen shareholders' rights and third parties protection, there was strong support for a fully integrated approach combining self-regulatory market solutions, adequate coordination of corporate governance codes and legislation where necessary. It was clear that over-regulation should be avoided and in particular that Directives are not generally an appropriate instrument in the corporate governance area because of the lack of flexibility and the risk that such directives could be followed by further overly prescriptive and detailed implementing measures.

More specifically in the field of corporate governance, a very large majority of respondents agreed with the Commission's assessment that there is no need for an

EU Corporate Governance Code. The view was generally expressed that corporate governance systems would develop and progress in a natural way under market pressure. The co-existence of different national codes was not perceived by issuers and investors as presenting any major difficulty. In other words there was support for the Commission's view that a European Corporate Governance Code would not offer significant added value but would simply add an additional layer between international principles and national codes. Among the other points emphasised in responses were support for a variety of measures to strengthen shareholder rights and to facilitate the exercise of those rights – something to which I will return in due course.

Some other issues such as a recommendation on directors' remuneration and a proposal for the collective responsibility of board members for financial and key non-financial statements have been addressed by the Commission since the responses were published at the end of 2003.

I am pleased to say that there was general support for the Commission's proposal to establish a European Corporate Governance Forum. The intention was that the Forum should encourage the coordination and convergence of national codes through regular high level meetings, but many respondents sought clarification on its terms of reference. Respondents also observed a considerable degree of convergence in existing EU Codes due mainly to market pressure. They therefore concluded that the Forum should not be a substitute for market forces in fostering further convergence and coordination of national codes but rather aim to disseminate best practices.

## **THE ROLE AND OPERATION OF THE EUROPEAN CORPORATE GOVERNANCE FORUM**

It is now clearly established that the key role of the European Corporate Governance Forum is to give strategic advice to the European Commission about its future policy on corporate governance. The Forum will need to look at the existing corporate governance codes in the Member States while best practice is also an area for attention. The international perspective, for example in relation to US developments and at the level of the OECD, is also important. The Forum members agree that our work should focus in the first place on listed companies, for example because of their stronger pan European dimension compared to non listed companies. We also need to bear in mind that any measure taken with a view to listed companies may have a certain "benchmarking" effect on non listed undertakings.

The Forum comprises fifteen members appointed by the European Commission. It is chaired by Dr Alexander Schaub as Director General, Internal Market, and the speaker appointed by the Forum is Bertrand Collomb. I am speaking to you today at his suggestion, as he is unfortunately previously committed to another engagement and regrets that he cannot himself provide a report to you.

This may be a convenient moment to mention briefly the recent Commission decision to establish a group of non-governmental experts on corporate governance and company law and to explain the distinction between the Forum and this new advisory group.

The intention of the Commission is that whereas the Forum is concerned with corporate governance issues only (although these may sometimes have company law implications) and at a strategic level of advice, the new advisory group is intended to provide very specific technical advice to the European Commission on drafting measures. It is intended to supplement rather than replace normal EC processes of consultation.

I should also say a few words about our method of operation. It is planned that we will have a few meetings per annum and so far have had two, on 20 January and more recently, 20 June. We aim to operate transparently according to agreed rules of procedure which are available on the website. You can also find there details of our agenda and minutes.

[[www.europa.eu.int/comm/internal\\_market/company/ecgforum/index\\_en.htm](http://www.europa.eu.int/comm/internal_market/company/ecgforum/index_en.htm)]

## **EXPERT REPORT ON EUROPEAN CORPORATE GOVERNANCE**

In order to give you a flavour of the final stages of preparation for the first meeting of the European Corporate Governance I should also refer to the Expert Report prepared for the first European Corporate Governance Conference held by the Government of the Netherlands in The Hague. This was also prepared by Jaap Winter and his colleagues and recalled some findings of the Winter Report on the appropriate European approach to corporate governance. Key components mentioned included enhanced corporate governance disclosure requirements and the development of national corporate governance codes in Member States based on a comply or explain mechanism.

The draft report was presented to the conference in The Hague and afterwards finalised on the basis of the discussions which took place during the conference.

As well as a survey of national developments in a number of countries, the report analyses some common themes.

Crucially it was noted 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 just to look at the various codes that have been produced but also to relate it to the underlying company law legislation. This is important since, despite a number of common themes in development, there is obviously considerable diversity in the corporate governance systems of Member States, to a good extent reflecting differences in share ownership structures.

Evidently, the mere fact that similar corporate governance issues are addressed by Member States in itself encourages the convergence of corporate governance regulation. The way that these issues are dealt with in Member States being different, due to different traditions, practices and legal structures, suggests that it is right for the EU not to impose common EU rules in Member States through formal harmonisation but through non binding recommendations. The process of convergence in these areas needs to be flexible. It is more important that Member States develop their regulatory environment along similar lines than to have uniformity on the detail.

As regards the use of codes or legislation to regulate corporate governance, legislation is obviously appropriate to ensure that essential legal infrastructure is available and operates efficiently. Voting rights is an example. Legislation is also appropriate to set generally accepted minimum standards.

Codes, based on comply or explain, are considered more appropriate where different solutions exist to achieve certain convergence codes and companies require flexibility to adapt to their own particular circumstances. The functioning and structuring of boards is an example of this.

This report also made some suggestions for the European Corporate Governance Forum's tasks. Among many useful suggestions, cross frontier listing and investment issues were mentioned, as were comply or explain mechanisms in different Member States and related enforcement.

I should also note that David Wright of the European Commission, who chaired The Hague Conference, drew certain conclusions at the end of the conference as to points of convergence and divergence. I should like particularly to mention the following points of convergence:

corporate governance is not a passing fad but a very crucial new subject for all companies and for economic reform, restoration of confidence in capital markets and long term economic growth and investments

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

clarity that there is an underlying movement underway in all Member States to improve the level of corporate governance standards

widespread support for encouraging shareholder participation in company meetings and to facilitate cross border voting.

It was against this whole background that the European Corporate Governance Forum selected the following priority subjects for attention during 2005.

## **OUR CURRENT AGENDA – PRIORITY SUBJECTS FOR THE FORUM**

The following are the priority subjects for the Forum's attention. As you might expect, we have made more progress with some of these than with others in our first meetings:

the role of shareholders, focusing primarily on shareholder rights. This work will take account of the outcome of the second consultation by the Commission on shareholder rights

questions linked to the principle of "comply or explain". This relates to enforcement of corporate governance norms mainly through market forces and shareholder rights

ways of improving the functioning of companies, focusing on the questions of internal control and independence of directors.

At last week's meeting of the Forum, we concentrated on shareholder rights and internal control, topics on which we will continue to exchange views at our next meeting in the Autumn. We plan to start discussion on comply or explain questions at our next meeting.

## **SHAREHOLDER RIGHTS**

Much of last week's meeting was devoted to a vigorous discussion of issues related to shareholder rights. The rights of shareholders and their relationship to companies are fundamental aspects of corporate governance. They raise both philosophical questions of approach and hard detailed practical issues of so called "plumbing".

Turning to the broader issues first, one might ask "what is the philosophical objective of corporate governance"?

An answer could be that shareholder sovereignty should be the guiding principle and the objective of corporate governance measures. Such an approach would focus corporate governance measures on increasing the role of shareholders and might help, for example, to resolve issues concerning one share, one vote.

Another approach might be to view the shareholders as owners of the company and therefore see the role of corporate governance measures as being to promote shareholder value as the supreme priority. This might inform one's view of the balance of rights between shareholders and management.

Yet another possibility might be to view the objective of corporate governance as building successful enterprises, something which could be interpreted as a rather wider societal objective than pure shareholder value. Such an approach might lend weight to the interests of stakeholders other than just shareholders or, perhaps favour longer term shareholders for example.

Whichever view is taken of such questions, there are risks if shareholder rights are wrongly judged. Inadequate shareholder rights clearly allow management to become entrenched which will bring its own risk for all parties. In such circumstances even unsuccessful management, if sufficiently entrenched, can preside over continuing poor performance and even outright failure if shareholder rights are inadequate, thus preventing the management from being challenged.

On the other hand, one could take the view that excessive intervention by shareholders in the role of management can lead to short term performance receiving excessive management attention, perhaps at the expense of longer term corporate development.

At any rate, it is recognised in the Forum that good corporate governance must provide a very clear distinction between governance, on the one hand, and management on the other. Managers must be allowed to conduct their activity with great autonomy while remaining fully accountable to shareholders. In other words, an appropriate balance must be found between the two crucial objectives of managerial entrepreneurship and shareholder control.

In order to address this issue we have considered why shareholder voting should be of concern and which are the issues on which shareholders should vote and when.

As to why shareholder voting matters, our discussion mentioned some important factors. If, for example, one takes as the objective of corporate governance the promotion of strong successful companies creating value for shareholders, then shareholder rights matter. This is because the validity of votes on important matters under company law is in substance open to challenge if only a small proportion of shareholders exercise their votes. Such a situation may leave companies vulnerable to a relatively small proportion of shareholders influencing the outcome on crucial issues if other shareholders are apathetic.

Perhaps the core idea is that an appropriate level of scrutiny by shareholders on key issues will make management perform better.

This should mean too that reliance on self regulatory market side pressures will remain a viable approach to corporate governance. This is vital as the alternative is tough and more detailed regulatory enforcement.

This is a particularly crucial issue – how do you make the market work rather than rely only on legal solutions? If we can make the market work there will be less of a legislative burden, less red tape and greater efficiency. Indeed one can see this as a constant theme underlying the work of the Forum.

Furthermore, if we succeed in building market side solutions in corporate governance, this should help to build stronger and better integrated financial markets in Europe. If shareholders are not powerful enough there is no market mechanism. Of course this is not just a question of corporate performance but also of investor protection, especially from abuse in scandals. The appropriate protection of investor rights and interests improves confidence in markets.

As to the issues on which shareholders should be entitled to vote, examples may include election and dismissal of directors, executive compensation, major corporate transactions and major changes in the bye-laws. These are some of the issues on which we have started discussion in the Forum.

Our discussions also touched on how we should approach some of these issues. One perspective is to consider whether shareholder rights are sufficient in practice to achieve some of the objectives mentioned above and to view some of the anomalies and limitations on shareholders' rights by reference to whether or not they are excessive and could be viewed as abuses. Promotion of best practices to bring about improvements and foster convergence should be an element of addressing these, in line with some of the background which I have explained earlier.

There is then the question of “who should vote”? In particular, should it be the ultimate investor as discussed in the first Commission consultation on shareholder rights? The point here concerns the entitlement to control the voting right, particularly in cross border investments, where shareholders invest in shares through chains of securities intermediaries. I do not want to go into this technical issue here, but it is clear that intermediaries would have a crucial role in any solution. It is also highly desirable that companies should not face uncertainty when they receive a vote from investors not directly linked to the share register or depository system; in other

words if the chain of voting entitlement for the ultimate investor is not demonstrated to the company. The question here is that while it is clear that the principle of encouraging shareholder voting for all the reasons explained favours doing something, which is the convincing and cost effective answer?

There are also many technical aspects to the effective exercise of shareholder voting rights, particularly in cross border investments. These concern topics such as notice of meetings, proxies, electronic voting, the agenda and information for general meetings, the right of shareholders to ask questions, the role of intermediaries, stock lending and depository receipt holders. In respect of solutions to such practical detailed matters, we need pragmatic solutions which will work and these necessarily seem to involve lots of technical detail. As they are a vital foundation for the exercise of shareholder rights in a consistent and practical way, the view of the Forum is that a directive is needed and it should be as precise as necessary to realise the objectives. This of course is in contrast to the general principle that in the field of corporate governance a principle based approach is in general the right way to give Member States and companies the flexibility they need.

On some of the other questions, further analysis would be helpful and of course the Forum looks forward to considering the response to the Commission's consultation paper on the enhancement of shareholders' rights. I should mention that those responses are due by 15 July at latest.

## **INTERNAL CONTROL AND RISK MANAGEMENT**

The Forum is aware that at the heart of the various corporate governance scandals over the last few years lie failures in listed company systems of risk management and internal control, in particular the apparent inability of such systems to avoid substantial misrepresentations in the financial statements of listed companies. Consequently, in looking for ways of improving the functioning of companies, risk management and internal control are important issues. We should recognise that in Europe, such issues are addressed in most codes of corporate governance, for example the OECD principles and the UK Combined Code.

It is probably worth making a brief survey of US and EU developments in this field.

The US Sarbanes-Oxley Act contains two sections introducing new requirements relating to risk management and internal control for SEC registrants. Section 302 requires the CFO of a company to maintain and regularly report publicly on their evaluation of disclosure controls and procedures that ensure that the information required to be included in reports filed with the SEC is recorded, processed, summarised and reported on a timely basis. The CEO and CFO must certify the information contained in quarterly and annual reports and the controls over reporting processes. Section 404 requires management to state publicly their responsibility for establishing and maintaining adequate controls over financial reporting, together with an assessment of their effectiveness. The external auditor must provide an audit opinion (apart from an opinion on the financial statements of the company as such) on management's assessment of the company's internal control over financial reporting and also provide their own opinion on the company's internal control over financial reporting. I should note that the SEC held a Roundtable in April to consider experience to date with Section 404. I attended that Roundtable and have some

personal impressions but I will not mention them here in the context of a report on the work of the Forum.

The proposed amendments to the 4<sup>th</sup> and 7<sup>th</sup> and 8<sup>th</sup> EU Directives will introduce certain requirements relating to risk management and internal control. The proposed amendment of the 4<sup>th</sup> and 7<sup>th</sup> Directives on annual accounts and consolidated annual accounts will introduce a requirement for listed EU companies to provide a corporate governance statement in their annual report which will contain amongst other items, a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process. The proposed amendment to the 8<sup>th</sup> Directive on statutory audit requires the audit committee of public interest entities (including listed companies) to monitor the effectiveness of the company's internal control, internal audit where applicable and risk management systems. This proposal does not seem to be limited to internal control and risk management related to financial reporting only. It clarifies also that the responsibility for the internal control system lies with the board of directors collectively and not only with the audit committee.

Several Member States have introduced new requirements relating to internal control and risk management in legislation, listing rules or corporate governance codes over the last few years.

I should also mention that my own organisation, FEE, the European Federation of Accountants, has published an extensive report in March this year on risk management and internal control in the EU. This discussion paper (which can be downloaded from [www.fee.be](http://www.fee.be)) has been provided to members of the EU Corporate Governance Forum.

The FEE paper provides a survey of national requirements in the US and nearly thirty European countries. It describes the source of these requirements, the types of risks to be addressed and whether they are concerned only with the management of risks or with disclosure as well. FEE also raises the question of whether conclusions about the effectiveness of controls should be published and whether auditor involvement is desirable.

In summary, the FEE discussion paper takes account of the fact that the proposed EU requirements are pretty high level, in line with the general EU approach to corporate governance previously described in this paper. FEE therefore is seeking to promote a discussion in this area about best practice, principle based requirements against the background of the various regulatory options and proposals. We would welcome comments to FEE by 31 July.

The essence of the FEE approach to these matters is that a robust debate is required in Europe on what might be the appropriate requirements to impose in relation to risk management and internal control before introducing such requirements. We believe that experience elsewhere, notably in the US, should be carefully assessed and that the costs and benefits should be carefully weighed, so that there is reasonable assurance that any new initiatives would provide clear benefits. For example, FEE is currently unconvinced about the potential merit of any EU measure to require publication of conclusions on the effectiveness of internal controls.

From the point of view of the Forum, there is a similar desire to carefully examine the lessons which may be learned from experience elsewhere before any further

legislative measures at EU level are contemplated in this field. The Forum also agrees that it would be necessary to strike a balance between identifiable benefits of any additional requirements and the costs and burdens that would result.

Given the impending legislation at EU level in the proposed modifications to the 4<sup>th</sup>, 7<sup>th</sup> and 8<sup>th</sup> Company Law Directives, risk management and internal control will remain highly important and topical issues.

To illustrate this point, I should refer to the very recent Review of the Turnbull Guidance on Internal Control. This was published by the UK Financial Reporting Council on 16 June 2005. I should like to quote the main findings of the review, which was carried out after an extensive evidence gathering exercise and consultation. The main findings are:

The evidence shows that the Turnbull Guidance has been successful in meeting its original aims and has contributed to a notable improvement in the overall standard of risk management and internal control in UK listed companies since 1999.

There was unanimous support for the guidance continuing to cover all material controls.

There was equally strong support for retaining the principles based approach of the current guidance.

There was very little support for public statements on the effectiveness of the internal control statement of the sort required under Section 404 of US Sarbanes-Oxley Act.

In short, this item may be expected to remain on the agenda of the Forum.

## **CONCLUSION**

I trust that I have been able to give you a flavour of the background to the Forum, its composition and working methods and of the discussion we have had on some of our priority subjects.

As I mentioned previously, we will continue our discussion on these issues and in particular address the topic of “comply or explain” in our next meeting in the Autumn. This will involve addressing enforcement of corporate governance norms mainly through market forces and shareholder rights, the advantages and constraints of the “comply or explain” approach, the relationship between law and regulation, especially concerning disclosure and transparency and whether the Forum will continue to have a general preference for market led enforcement as being most effective in this field.

Thank you for your attention.

**David Devlin**  
**28 June 2005**