BUSINESSEUROPE

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CONSULTATION ON CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS AND REMUNERATION POLICIES

Introduction

BUSINESSEUROPE welcomes the opportunity to submit its comments in the context of the consultation on corporate governance in financial institutions and remuneration policies.

Although the green paper mainly targets financial institutions, it also discusses more general corporate governance issues such as directors' remuneration and board structure. Therefore, BUSINESSEUROPE would like to restate its position regarding corporate governance in general whilst addressing some of the specific questions contained in the green paper.

BUSINESSEUROPE has always been an active participant in the debates on corporate governance and has been a contributor to the Riskmetrics Study on *'comply or explain principle'* published in September 2009[1].

As we have highlighted in the past, good and efficient corporate governance is of utmost importance to companies and their stakeholders. To achieve this goal it is key to find the appropriate balance between hard law and soft law when it comes to defining corporate governance principles.

The Riskmetrics Study shows that the distribution between law and codes depends on a number of factors, including legal tradition, ownership structures, and the maturity of the corporate governance tradition, despite some general trends that can be observed at European level. The EU should avoid falling into the trap of over-regulation. This could hamper or even stop market driven evolution of corporate governance practices, disrupt the delicate balance found at national level and might also lead to '*regulatory fatigue*'[2]. Some corporate governance rules are likely to be best dealt with, and updated, more efficiently at national level. Solutions based on 'hard law' should be kept to a minimum and only for those aspects for which professional regulation cannot provide satisfactory results.

[1] Riskmetrics' *Study on Monitoring and Enforcement practices in Corporate Governance in the Member States*, September 2009, available at <http://ec.europa.eu/internal_market/company/ecgforum/studies_en.htm>

[2] See, speech by Charlie McCreevy, European Commissioner for Internal Market and Services, on 'Governance and Accountability in Financial Services', Economic and Monetary Affairs Committee of European Parliament, 1 February 2005, SPEECH/05/64.

In this context, BUSINESSEUROPE agrees with the wording of the Commission's Staff Working Document accompanying the green paper whereby the purpose of this exercise should be to '*fine-tune the balance between soft and hard law, and ensure a strict monitoring of voluntary practices and adequate enforcement of legislation*'[3].

Principles for an EU approach to corporate governance

BUSINESSEUROPE would like to reiterate the principles set out below to serve as reference criteria for EU intervention or non-intervention in the area corporate governance.

- **Subsidiarity** – The EU should only intervene when it is proven that the foreseen objective cannot be reached by national action. EU action should not disrupt the delicate balance found at national level, which takes into account national traditions and cultures.
- **Principle-based approach** – In light of the subsidiarity principle, in any EU intervention, a general principles-based approach should prevail over a rules-based approach. This would allow a degree of flexibility necessary for companies to develop the governance model best suited to them.
- **Market-driven approach** – In BUSINESSEUROPE's view, corporate governance is better served by flexible self-regulatory initiatives as opposed to regulatory interventions. Over-regulating is a disincentive for companies to go beyond legislation and adopt corporate governance best practices.
- **Comply or explain** – When a corporate governance code is applicable, companies should either conform to the provisions of that code, or provide an explanation as to why the principles have not been followed. As stated in the 1992 Cadbury Report, the 'comply or explain' route should enable companies to "*strike the right balance between meeting the standards of corporate governance expected of them and retaining the essential spirit of enterprise… Raising standards of corporate governance cannot be achieved by structures and rules alone (...)* ". This 'comply or explain' approach has been in operation for more than ten years and the flexibility it offers has been widely welcomed both by company boards and by investors. This wide acceptance has been revealed by the recent external study performed by Riskmetrics published in September 2009. Most companies – 86% of the sample taken – disclosed comply-or-explain information although this study suggests room for improvement in terms of level and quality of information on divergences, and on the level of monitoring by shareholders and authorities.
- **Transparency and disclosure** – Transparency is an essential ingredient for any form of outside monitoring. It is very important for the shareholders and investors to see the manner in which a company follows the recommendations on corporate governance. Transparency enhances confidence in a company.

[3] Commission Staff Working Document, *Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices, p. 4. Also available at* <*http://ec.europa.eu/internal_market/company/docs/modern/sec2010_669_en.pdf* >

- **Global orientation** – EU policy should be oriented towards and take into account the global environment in which European companies inevitably evolve. Adding an additional and possibly contradictory EU layer of regulation would be a hindrance to achieving the goals of corporate governance.
- **Competition** – This should be encouraged between national systems so that society can benefit from an emulation effect. Competition in the field of legal systems stimulates legal innovation. In this context, the EU should ensure that Member States mutually recognise each other's legal systems.
- **Better regulation** – Impact assessments and proper consultations are the basis of good regulation. Consultation remains one of the basic principles of participatory democracy but consultation needs to be carried out in the right conditions: sufficient time for considered responses and a weighted analysis of responses received are fundamental ingredients for successful consultations.
- **No 'one size fits all'** - in corporate governance '*one size does not fit all*'. Companies should have the flexibility to design effective corporate policies tailor-made to their corporate objectives and goals. "Best practices" cannot simply be copy-pasted on to reality. Instead, they need to be adapted to the company's and to its country's characteristics.

In BUSINESSEUROPE's view, these principles should remain the main guidance for EU policy-makers. The philosophy of corporate governance rules in the EU is based on professional regulation. Regrettably, this is not sufficiently emphasised in the green paper. Solutions based on 'hard law' should be kept to a minimum and only for those aspects for which professional regulation cannot provide satisfactory results. In this fast-moving area, corporate governance codes are the best means of promoting the right corporate behaviour. They are flexible, easy to implement and update and allow for deviations (with explanations).

BUSINESSEUROPE agrees that the 'comply or explain' principle should be strictly applied and that whenever a company departs from a provision of a code, it should explain why the objectives will be better reached by other means. The focus should be more on monitoring and effective application of corporate governance rules.

BUSINESSEUROPE response to specific questions of the green paper

BUSINESSEUROPE has the following comments as regards some of the specific questions in the green paper, namely questions concerning boards of directors, risk-related functions, shareholders, effective implementation of corporate governance principles and remuneration:

Question 1.1. Should the number of boards on which a director may sit be limited (for example, no more than three at once)?

BUSINESSEUROPE believes that board composition is a corporate governance code issue, on which the principle 'comply or explain' should be applied. We see no need for additional measures at EU level aimed at harmonising existing national rules or corporate governance codes.

Fundamentally, the board is in the right position to assess the specific circumstances of each individual director, and to decide whether that person can meet the commitments. Ultimately, the decision on who should be a board member should be vested in shareholders who can decide to appoint a new board. Therefore, it is essential that shareholders receive proper and timely information on candidates nominated for election or re-election to the board.

A limitation of the number of directors' mandates would be complicated to put in practice given the number of different situations: whether the director has (or not) an executive role, sits in one or more board committees, sits in boards of directors from companies in the same group, or whether it is a listed or non-listed company. This is why this matter should be left to corporate governance codes which rely on the 'comply or explain' principle and allow the necessary flexibility.

Question 1.3. Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?

Companies' needs in terms of the profile of its directors vary over time. The experience, qualifications and other relevant skills of directors should be disclosed to the shareholders, as well as the information thereon with respect to nominated and incumbent directors to make sure that shareholders can take an informed decision in the election of directors. Still, the focus should be on whether the board as a whole fulfils all the key qualifications.

Question 1.4. Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?

BUSINESSEUROPE sees added value in having diversity in boards in terms of gender, nationality, professional background and expertise. However, when appointing a new board director it is important to consider not just one but several of these characteristics. Skills and competence should be the decisive factors, but when candidates meet the same requirements, the codes should encourage the nomination of more women on boards of companies.

For BUSINESSEUROPE, the issue of size and composition of the board should exclusively be an issue for the competent corporate bodies of the company. What is an appropriate composition of the board varies from company to company depending on the company's operations and phase of development. The realisation of this appropriate composition is also dependent on factors which are (partially) beyond the company's control, such as the availability of qualified candidate board members. Therefore, it is not possible for regulations to ensure that each board gets the most efficient and optimal composition. In fact, regulations which endeavour to do so, may very well be counterproductive as these would restrict the free choice between candidate board members in that they could disqualify candidates which would otherwise qualify in all respects. It ought to be the competent corporate bodies who freely decide the composition of the board so that it has the key qualifications that companies believe are the best for the company's profitability and prosperity.

Question 1.5. Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

The evaluation of the functioning of the board is very important. It seems suitable that the chairman of the board is responsible for ensuring that such a process of evaluation is accomplished regularly. The chairman is the person who best knows how the work of the board has functioned and should therefore have the central role in the evaluation. Mechanisms of professional evaluation, used in a number of Member States, could work as a best practice in this regard.

BUSINESSEUROPE believes that the evaluation of the functioning of the board is a corporate governance code issue and need not be addressed at Community level.

Question 1.6. Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

The importance of (market driven) evolution is not to be underestimated. As an example, some financial institutions established a risk committee well before this was recognised as a best practice in hard or soft law. The fact that it may be appropriate for some companies to set up a risk committee within the board of directors does not mean that it is equally appropriate for others. Risk management is a core task for directors and the supervisory board. Setting up a risk committee does not necessarily place risk management at the centre of directors' and board members' awareness, it might even be that liability with respect to risk management becomes more diffuse by setting up yet another body to handle the company's risk management. Therefore, the decision on whether or not to establish risk committees should be left to companies.

Question 1.8. Should the chairman of the risk committee report to the general meeting?

The committees within the board of directors are advisory bodies of the board of directors. For this reason, the chairman of the risk committee should report only to the board of directors. The board of directors (its chairman or the CEO) will report about this specific matter during the general meeting.

Question 2.5. Should executives be required to approve a report on the adequacy of internal control systems?

BUSINESSEUROPE acknowledges that it is important that companies periodically review whether their internal control systems are adequate but considers an annual board report on the adequacy of all internal control systems inappropriate and unnecessary.

Still, BUSINESSEUROPE is concerned that such a report would become an excessive burden on companies as its scope would go far beyond the scope of the control statement pursuant to section 404 of the US Sarbanes-Oxley Act. The report referred to above would not only cover the financial reporting related control systems (the scope of SOx 404) but also all other internal control systems. In this regard, it should also be noted that the applicability of SOx404 to US listed financial institutions did not prevent the financial crisis to originate in the US, let alone that it did not make US financial institutions immune against it.

Question 5.1. Should disclosure of institutional investors' voting practices and policies be compulsory? How often?
Question 5.2. Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.

For BUSINESSEUROPE, this topic should be left to corporate governance rules at national level rather than prescriptive rules at EU level.

BUSINESSEUROPE acknowledges that the role of institutional investors is fundamental to develop good practices in corporate governance. It is important that they disclose their voting practices and policies. In order to solve the lack of engagement by institutional investors, a duty to adhere to a national code of best practices could be envisaged.

Question 5.3. Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to 'empty voting'?

BUSINESSEUROPE agrees that creating a principle of identification of shareholders would help to improve company-shareholder engagement hence reducing the risk of abuse connected to 'empty voting'.

Question 6.1. Is it necessary to increase the accountability of members of the board of directors?
Question 6.2. Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?

BUSINESSEUROPE understands both questions 6.1. and 6.2. in the light of the comments made in the Green Paper with respect to the (perceived) lack of effectiveness of the OECD principles, the recommendations of the Basel Committee and Community legislation, in particular the "corporate governance statement" required pursuant to the 4th Company Law Directive.

However, BUSINESSEUROPE believes that increased accountability or civil and criminal liability of board members is not the appropriate remedy to solve these application "deficiencies".

BUSINESSEUROPE is concerned that, in a general sense, increased civil and criminal liability will be detrimental to entrepreneurship as this would add wrong stimuli to board decision making. Increased civil and liability would bias boards towards choosing safe options such as avoiding or postponing difficult decisions and against pro-active decision making or adequately responding to challenges that come up. Furthermore, it is highly questionable if civil or criminal liability lies in the regulatory competence of the EU.

Question 7.1. What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?

BUSINESSEUROPE acknowledges the importance for a company's reputation that remuneration levels of its executives are legitimate, perceived as reasonable and justified in the light of: the level of responsibility of executives, the company's strategic development and the company's results. Remuneration policy should also be aligned with long-term objectives and avoid reward for failure.

Remuneration of company directors is primarily a matter for the shareholders to bring up through their representatives on the board. The board must always be free to decide on the content of remuneration schemes while still taking responsibility for those decisions.

Currently, a heightened debate is going on about remuneration paid to directors. So it is understandable that questions about tightening the existing laws have surfaced. One must be cautious when formulating rules; a thorough analysis built upon a long-term perspective with different economic climates and contexts must be taken into consideration. Too much regulation in this area would affect the recruitment of skilled managers who would seek out companies where the regulatory frameworks are not so stringent. For example, in recent years, private equity companies have been a strong competitor to listed companies in terms of attracting good leaders.

For BUSINESSEUROPE, one of the main issues at stake is a transparent remuneration policy and a clear relationship between a company's performance and the remuneration of people responsible for that performance.

Businesses have a key role to play in this debate through adoption of transparent procedures and by complying with corporate governance codes. Therefore, the emphasis should be shifted from more regulation to better monitoring and effective application of corporate governance codes. The Commission's recommendations on remuneration of 2009 are gradually being implemented by Member States and companies. More time should be given to companies to adapt to those recommendations.

For BUSINESSEUROPE, it is also important to distinguish between financial and non-financial institutions when discussing legislative intervention on directors' remuneration.

A remuneration policy should be formulated so that it drives the behaviour of senior executives according to the owners' objectives. However, it may be technically difficult to construct such systems and to discuss these at a general meeting, particularly in terms of detail; this would not be appropriate. This is why shareholders delegate their powers to the board in which they vest their trust. If the shareholders believe that the board is not doing its job, they can always decide to appoint a new one.

In conclusion, BUSINESSEUROPE is of the firm opinion that remuneration issues are best tackled within the framework of professional regulation and transparency.

Question 7.2. Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?

As already mentioned, BUSINESSEUROPE is of the opinion that there is no need for additional measures at EU level on remuneration for directors of listed companies. Consequently, stock options should not be addressed by the Commission.

In the investor community there are differing opinions as to whether or not stock options should be granted to directors and senior executives. Stock options are not appropriate for all organisations but they are for some, especially start-up companies.

Question 7.3. Whilst respecting Member States' competence where relevant, do you think that the favourable tax treatment of stock options and other similar remuneration existing in certain Member States helps encourage excessive risk-taking? If so, should this issue be discussed at EU level?

This issue should not be discussed at European level.

Question 7.4. Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?

As explained above, BUSINESSEUROPE sees no need for further EU legislative measures on this matter.

Question 7.5. What is your opinion of severance packages (so-called 'golden parachutes')? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?

BUSINESSEUROPE is of the firm opinion that it is not necessary to regulate severance packages at EU level. As mentioned above, each board and a company’s shareholders should decide how a remuneration programme should be formulated based on the company’s specific situation.

What is key is to ensure adequate transparency with regard to notice periods and to termination payments. The latter payments should be provided for in detail contractually (the contract should explain what elements are to be taken into account). In any case, BUSINESSEUROPE opposes reward for failure.