# Financial Law Institute

Statements & Conferences

**S&C 2010-06**

**Eddy WYMEERSCH**

# Ongoing developments in European Corporate Governance

**December 2010**

S&C 2010-06

**Eddy WYMEERSCH**

# Ongoing developments in European Corporate Governance

## Abstract

**This paper contains the keynote speech delivered on December 6th, 2010 by Eddy Wymeersch, Chairman of the European Corporate Governance Institute at the Xth Corporate Governance Conference, Brussels. Apart from an overview on corporate governance elements in different EU work streams, it calls attention to the link between corporate governance and short termism, the questions raised by the increasing tension between government regulation and the corporate governance codes, and finally the new focus on the shareholders, both in EU initiatives and in the UK, where the stewardship code has received much attention.**

Instituut FINANCIEEL RECHT FINANCIAL LAW Institute

© Financial Law Institute, Universiteit Gent, 2010

UNIVERSITEIT GENT

# Ongoing developments in European Corporate Governance

There are four topics I would like to deal with:
- Ongoing EU Commission work
- Short-termism
- Voluntary code v. Regulation
- The role of shareholders.

## Ongoing Commission work

As you all know for sure, the Commission is in the process of undertaking work in the Corporate Governance field, first for financial institutions1, later for all other listed companies. The first part of the work has led to a Green paper and the summary of responses has been published. A white paper is expected for February-March.

At that time the second consultation will be launched dealing with non-financial listed companies.

In the meantime, work is undertaken on the review of the securities directives, being MAD, prospectus, Transparency (e.g. on empty voting) and Mifid. On Takeovers an external study will be undertaken, the contractor having been designated.

Of importance to CG is of course also the work on CRD III, especially here on Remuneration, detailed in the rules in the annex. CEBS has published extensive guidelines that are more than worthwhile to be read2.

Similar guidelines on remuneration are part of the already adopted directive on alternative investment funds, AIFMD3. They also contain some rule that affects governance i.e. with respect to the investee companies (essentially disclosures, and prohibition of “asset stripping”)
To be followed is the work on the Securities Law Directive, where some provisions address the exercise of voting rights on listed companies, especially in the context of securities in a multiply layered account holding system. The present state of preparation is unclear: only a consultation document has been published up to now4.

Finally, one should also mention the work on auditors and audit services, the consultation on which closes the day on the 8th of December5.

Let me conclude this overview with a general policy remark: one sees that the Commission has been very successful in the field of financial services, essentially securities. In the company law and corporate governance field, it has not performed as well. There are some disparate topics, but central questions dealing with how to support our business structure for making Europe more performing are not dealt with, esp. here with reference to SMEs. This is regrettable. The reasons for this difference of progress may be many. One of them being the restrictive attitude adopted by the MS in the company law field. The changes to the capital rules in the second directive are an example: no significant simplification in the directive was introduced, but this has not prevented the member states to adopt company types with 0 capital. The markets

1 http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf
2 http://www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP41-CP50/CP42.aspx
3 The text of which is not yet pubicly available.
4 http://ec.europa.eu/internal_market/consultations/docs/2010/securities/consultation_paper_en.pdf
5 http://ec.europa.eu/internal_market/auditing/otherdocs/index_en.htm

overtake the unwilling legislators for lack of understanding. This is also the case on the issue of company mobility, the so-called 14th directive. And I could mention several others.

## On short termism

As most of the corporate governance discussion relates to companies the shares of which are traded on open markets, the influence of these markets on company conduct has become increasingly dominant. These days the force of the markets is visible in the sovereign bond markets as well. The bond investors have become the equivalents to the activists in companies.

In the corporate field, markets, i.e. investors, large and small, institutionals, hedge funds, you name it, have been pressing companies for results on an ever-shorter time span. Three monthly reporting, earnings forecasts and trading updates, a continuous stream of analyst reports and ever shorter trading cycles. But also accounting rules - IFRS – and prudential rules – Solvency II – influence negatively long-term ownership of equity, leading to a significant reduction of equity positions in their portfolios. And what about the proposal to re-appoint the CEO on a yearly basis, as applied in the UK? Or about the rules whereby Investment funds have to stand ready at any time for shareholders that want to redeem their entire portfolio, although very few actually do so? If one would apply that rule in banking, all banks would indeed be insolvent. And the different tax treatment of interest on bonds v. dividends of equity, implying shorter-term assets. The list of matters in which the regulation has bent company conduct to the short term is much longer: the phenomenon is deeply embedded in our regulations, and in the markets.

Short termism leads to higher volatility, usually less investment e.g. in R&D, but also instability of employment, as companies lay off immediately due to changed market perceptions. There is no room for long-term strategies, for building value over the cycle, or the generations. And some have even linked the subprime crisis to short termism both at the producer end – originators did not care about the quality of the loans that were sold, provided they got their fees - and the investor end, product being bought without much analysis, point to overheated conditions. A critical study of the US Aspen Institute on “Overcoming short termism” list all these features leading to short termism from investors, and calls for stricter fiduciary duties for financial intermediaries. But that will no do: stronger measures are needed, thereby addressing management and boards of companies, whereby some of the issues will be dealt with in governance terms. After much hesitation the governance world has been obliged to accept the legislators’ intervention in the field of management compensation, what has now become almost a separate part of the regulatory practice. This new body of rules aims at reducing short termism by linked compensation to longer term, less risky objectives.

## Voluntary code vs. Regulation

And that brings me to the third topic, the relationship between governance codes and regulation. After the crisis, but already before the crisis, the trend goes in the direction of more regulation: the audit committees have been introduced, the remuneration question is settled in directives and national laws, and the European Commission is digesting the answers to its Green Book, that will likely result in more

regulatory initiatives. It is regrettable that the Corporate Governance Codes that offered flexible adaptable solution are now in retreat. By the way, the US stepped in with very heavy boots with the Sarbanes-Oxley Act, but was that more effective in avoiding the governance breakdown that we have witnessed?

The main problem with CG codes is their implementation: I can here refer to the Study undertaken at the request of the EU Commission on that topic by Risk metrics, with the Support of Business Europe Ecoda and Landwell/PWC6 that identified wide support for the "comply or explain" approach, but also pointed to the weaknesses in terms of compliance and monitoring. It has been proposed to involve more actively the securities supervisors, what is done in Portugal and Spain, and to some extent in France as well. This type of monitoring is based essentially on the verification of the legal and other conditions, but does not enter into the actual governance in depth. It says e.g. who is not an independent director, but not who is independent! A private body, with experienced businessmen consecrating a substantial part of their time to dialogue with boards and management would probably be more effective, but than it has to have legal powers, real teeth, able to protect its information for fear of libel actions, and when serious breaches are discovered, be able to impose effective sanctions, e.g. not only disclosure but the right to submit a motion to the board, or even to the AGM. This in-between house - privately organised but with public support and oversight - might, if adequately supported by the legislator, have more grips on unhealthy governance situations and practices that any formal check on formal compliance. It could even check the quality of directors, by following a vetting procedure similar to the one the FSA is applying for future directors of financial companies.

Who else will be able to be the guard for good governance? The standard answer is "the markets". And indeed, the investors, especially the activist ones, have been quite active in imposing some governance efficiency, especially in the larger firms. The turnover of CEOs is evidence to the powerful influence markets can have. The effects of shareholders' action is however different in systems where ownership is very dispersed, as is the case in the UK, and to a lesser extent the US, as compared to most other jurisdictions, in continental Europe, or the Far East, where block holders, or controlling shareholders have a large say in company conduct, reducing the impact of the markets.

## The role of shareholders

The fourth topic in my talk deals with the new role of the shareholders. Looking at it from a distance, it is striking that shareholders have become more prominent in the governance debate. In the past, they were not very much considered part of the picture: see the governance codes, where often they are not mentioned at all. This is now rapidly changing:

The shareholder rights directive, also with its provisions on activating voting by shareholders, whether by proxy or through electronic means, the planned securities law directive, that would better organise the exercise of voting rights in case of multilayered securities holdings, but also the anxiety about empty voting and hidden ownership – see LVMH v. Hermès recently – has activated the debate about the shareholders' role in the governance world. The issues are different, depending on the ownership structure. So

6 6 MONITORING AND ENFORCEMENT PRACTICES IN CORPORATE GOVERNANCE IN THE MEMBER STATES, Sept 2009.

e.g. would the presence of block holders de facto curtail the influence of other shareholders, even in cases where conflicted transactions are entered into? But generally spoken, it would seem logical hat block holders, and especially controlling shareholders hold long-term views and are likely to develop more long-term investment projects.
In companies where ownership is very dispersed, the influence of shareholders will be essentially translated through the markets and therefore will be characterized by a short-term perspective. Originally based on a report by Sir David Walker, the UK is now following the path to urge large institutional investors to engage more actively with the companies in which they invest, and rather than trading the shares that they would exercise influence on their investees. The scheme is based on the cooperation of the asset managers, who are invited to sign up to a declaration of "stewardship" for the assets they manage, invitation supported by a regulatory provision adopted by the FSA. The approach could be adapted in other European states where institutionals play a sufficiently prominent role in companies, such as the Netherlands, with respect to the large pension funds. But in other states, the active involvement of the widely spread shareholders, especially where block holders *de facto* decide, will be a difficult exercise. The more active use of a simplified proxy solicitation facility by these engaging shareholders might contribute to activate the shareholdership, as by bundling votes, it would multiply their authority to dialogue with boards and management. The more widespread use of shareholder committees – Swedish style - has also been advocated.

Today we are still far away from the responsible empowerment of the shareholder that some would call for. It will be interesting to read what will be the proposals of the European Commission on this topic, as they will be released early next year.

## Conclusion

The corporate governance debate is become more and more prominent in several fields of public action.
It has left the field of private relations and entered public policy, in terms of financial stability and systemic risk sensitivity. Corporate governance techniques are used for purposes that are not directly related to objectives of maximising governance of companies. This trend is likely to continue. Notwithstanding the legislative pressure, the traditional strand should be further pursued and refined.

The contribution of a conference like the present one is therefore essential in further stimulating exchange of ideas and experiences, and supports the debate among informed parties.

# Financial Law Institute

The **Financial Law Institute** is a research and teaching unit within the Law School of the University of Ghent, Belgium. The research activities undertaken within the Institute focus on various issues of company and financial law, including private and public law of banking, capital markets regulation, company law and corporate governance.

The use and further distribution of the Statements & Conferences is allowed for scientific purposes only. Statements & Conferences are published in their original language (Dutch, French, English or German) and are provisional.

© Financial Law Institute
Universiteit Gent, 2010

More information about the Financial Law Institute and a full list of statements & conferences are available at:
**http://www.law.UGent.be/fli**