

# EC Corporate Governance Action Plan: Implications for Regulators

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# General Points

- In designing Action Plan, EC adopting CG priorities and agenda of High Level Group:
  - corporate governance disclosure
  - shareholder participation
  - board structure, independence non-executive director
  - director remuneration
- CG reform process is also prime mover in regulation of financial reporting by listed companies and of auditing

# European Scandals Accelerated EC's Corporate Governance Reform Process

- Reforms address accounting & boardroom scandals by—
  - Mandatory audit and disclosure rules
    - New disclosure requirement for material off balance sheet activities and related party transactions not conducted under normal commercial conditions
    - Annual corporate governance statement
    - Rotate audit partner
  - Recommendations
    - Shareholder rights
    - Transparency on boardroom pay
    - Independent board members

# Proposed Amendments to existing 4th and 7th Directives

- Collective responsibility of board for annual accounts & report
    - Prognosis: conforms with current law in many MSs
  - Information disclosure: scope--
    - Related party transactions: disclosure of information affiliated companies & loans & advances to management board
    - Requirements:
      - RPTs other than arm's length
      - Requires disclosure of business purpose
      - Material transactions
      - (some costs anticipated for mid-size firms, cf DTI (2005: 66)
- Benefit/cost analysis—may have significant corporate governance benefits in light of scandals, cf. Parmalat

# Special Purpose Vehicles—post Parmalat inspired reform

- Greater transparency of SPEs
  - Mandate disclosure requirement in notes for material off-balance sheet arrangements
  - Justified—true and fair view of firm's financial statements
  - Issues: scope, only material arrangements must be disclosed
  - Benefit/cost analysis—few firms impacted; low cost for disclosure; many prospective CG benefits

# Disclosure: Annual Corporate Governance Statement

Statement required in annual report:

Report on operation of shareholder meeting

Whether the board has a code that applies to the company as to what extent the company complies with it or not

Description of the internal control and risk system

Policy regarding major shareholding, composition and operation of board and its committees, operation of shareholder meeting

# Assessment

- Little problem supplying information; but may entail higher costs regarding specific additional information, etc.
- Problems—25 different company law rules on statement (eg, audited/non-audited; etc.)
- Best left for national corporate governance codes to determine

# Shareholder Rights

- Dissemination of information before general meeting
- Criteria for participation in general meeting (e.g., record date system), minimum standards to ask questions & table resolutions
- Electronic voting or by post or proxy
- More use of website disclosure (e.g., information following general meeting)
- Little opposition by special interests

# Recommendation on Non-Executive Directors

- Non-binding recommendation aimed at having MSs introduce framework on: minimum set of detailed principles used by listed companies;
  - Managerial and supervisory body should include appropriate balance of executive and non-executive directors
  - Independence—minimum criteria (when free from any relationship with company, controlling shareholder or management);  
Board organized so that sufficient number of independent directors play key role where there are conflicts of interest  
Nomination, remuneration, and audit committees should make recommendations aimed at preparing decisions by board itself

# Shareholder Communication

## *Requirements:*

Whether company has a sufficient number of independent directors

Names of members and number of meetings

Functions of the nomination, remuneration and audit committees

Evaluation of the board, annual disclosure on internal organization and procedure

Disclosure requirements on qualifications of directors and appointments

# Shareholder Communication

Nomination Committee

*New requirements:*

Minimum qualifications: majority of independent non-executive directors

Process of identifying nominees

Source of nominees

Succession planning

Consider shareholder recommendations

# Shareholder Communication

## Remuneration Committee

### *Requirements:*

Whether company has a remuneration committee composed exclusively of non-executive directors

Names of members and number of meetings

Functions of the committee, use of consultants

Proposals made for remuneration policy, total and individual remuneration

# Shareholder Communication

Audit Committee  
*New requirements:*

Review and monitor financial information, internal control systems, ensure effective audit

Make recommendations to board on selection of auditor, monitor services (including non-audit services), review effectiveness of auditor

Independence of members, induction program for new members

Policy on reviewing existing auditor's work

# EU Reform on Executive Remuneration

- Aim: address weaknesses in pay-for-performance link:
  - CEOs prefer to avoid index options
  - Pay is not actually performance based; ie, keyed to shareholder value creation
  - The usual practice for stock options, whatever their merits, is to fix the exercise price at the time of the grant (only 5% of companies price options out of the money)
  - Insulated from stock price volatility—through re-pricing or re-loading of options

# EU Approach—comply & explain

- Disclosure in annual report or separate document:
- General information on forward-looking remuneration policy (details of fixed & variable, performance criteria, etc)
- Total remuneration to be disclosed in detail; covers salary & fixed elements, including bonuses and profit-sharing schemes, termination payments & other non-cash benefits (Similar to CA 235, Pt 3)
- Detailed information on share options granted, exercised, unexercised and any changes in terms and conditions and on grants under share schemes

# Benefit of EU Recommendation on Executive Remuneration

- Advisory vote: allows shareholders to express opinion about the quality of information disclosed
- Effect:
  - Impact is significant (Deloitte study of directors' remuneration Report, 2002—Regulations 2002 S.I. 2002/1988)
  - Tighter pay-for-performance link
  - Complete reduction in notice periods to 1 year
  - Removal of new plans on automatic vesting
  - Increased rate of ex ante consultation with shareholders

# Corporate Governance Codes

- Corporate governance regulation in Europe
  - no EU code now
  - co-ordination of Member States' efforts (standards, monitoring, enforcement), designate national code, strong involvement of practice, continuous debate:
    - Audit committee—better information & access
    - Conduct of independent directors
    - Internal system; self-assessment, etc.
  - Concerns: application of national codes to non-listed companies, comply or explain may induce to lock-in effect (sticky mechanism that contributes to box-ticking)
  - Codes: may have no legal basis in most MSs, but some applications of the code may become mandatory in jurisdictions

# Conclusion

- Reaction to European corporate governance scandals has not, like US, led to significant costs associated with over-reaction by Congress
- Preference for combination of directives and recommendations reflects history of EC company law making (eg, mandatory rules for audit, etc.)
- Still, more flexibility needed--Commission has responded positively to criticisms