Corporate governance framework for European companies

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PURPOSE: to launch a public consultation on ways of improving corporate governance in the EU (Commission Green Paper).

BACKGROUND: corporate governance is traditionally defined as the system by which companies are directed and controlled and as a set of relationships between a company's management, its board, its shareholders and its other stakeholders. The corporate governance framework for listed companies in the European Union is a combination of legislation and 'soft law', including recommendations and corporate governance codes. While corporate governance codes are adopted at national level, Directive 2006/46/EC promotes their application by requiring that listed companies refer in their corporate governance statement to a code and that they report on their application of that code on a 'comply or explain' basis.

Corporate governance and corporate social responsibility are key elements in building people's trust in the single market. They also contribute to the competitiveness of European business, because well run, sustainable companies are best placed to contribute to the ambitious growth targets set by 'Agenda 2020'. In its Communication "Towards a Single Market Act" the Commission stated that it is of paramount importance that European businesses demonstrate the utmost responsibility not only towards their employees and shareholders but also towards society at large.

The G20 Finance Ministers and Central Bank Governors Communiqué of 5 September 2009 emphasised that actions should be taken to ensure sustainable growth and build a stronger international financial system.

Some relevant issues had already emerged in the context of the Green Paper on Corporate Governance in Financial Institutions and remuneration policies adopted in June 2010. For example, shareholder engagement matters not just to financial institutions, but to companies generally.

CONTENT: the purpose of this Green Paper is to assess the effectiveness of the current corporate governance framework for European companies. It addresses three subjects which are at the heart of good corporate governance.

The board of directors: high performing, effective boards are needed to challenge executive management. This means that boards need non-executive members with diverse views, skills and appropriate professional experience. Such members must also be willing to invest sufficient time in the work of the board. The role of chairman of the board is particularly important, as are the board's responsibilities for risk management. The Green Paper discusses means of ensuring the effective functioning of the board of directors and the diversity of its members, through encouraging, for example, gender diversity, international diversity and professional diversity. It also discusses risk management and directors' remuneration. It also asks whether disclosure of remuneration policy, the annual remuneration report and individual remuneration of directors be mandatory.

Shareholders: the corporate governance framework is built on the assumption that shareholders engage with companies and hold the management to account for its performance. However, a lack of appropriate shareholder interest in holding financial institutions' management accountable contributed to poor management accountability and may have facilitated excessive risk taking in financial institutions. There is evidence that the majority of shareholders are passive and are often only focused on short-term profits.

It therefore seems useful to consider whether more shareholders can be encouraged to take an interest in sustainable returns and longer-term performance, and how to encourage them to be more active on corporate governance issues. Moreover, in different shareholding structures there are other issues, such as minority protection. The Paper also asks whether EU rules are needed to enhance disclosure and management of conflicts of interest; whether there is a need for a European mechanism to help issuers identify their shareholders and benefit cooperation between investors.

Application of the 'comply or explain' approach: under the 'comply or explain' approach, a company which chooses to depart from a corporate governance code recommendation must give detailed, specific and concrete reasons for the departure. The general introduction of the 'comply or explain' approach in the EU has had its difficulties. A recent study showed that the informative quality of explanations published by companies departing from the corporate governance code's recommendation is - in the majority of the cases - not satisfactory and that in many Member States there is insufficient monitoring of the application of the codes. It is therefore appropriate to consider how to improve this situation. Some adjustments appear necessary to improve the application of the corporate governance codes. The solutions should not alter the fundamentals of the 'comply or explain' approach but contribute to its effective functioning by improving the informative quality of the reports. However, these solutions are without prejudice to the possible need to reinforce certain requirements at EU level by including them in legislation rather than making recommendations.

Two preliminary questions also deserve consideration.

- European rules on corporate governance apply to 'listed' companies (i.e. companies that issue shares admitted to trading on a regulated market). They generally do not distinguish according to company size or type. The question is whether the EU should have a differentiated approach and how best to take account of the potential difficulty of applying some corporate governance practices across the range of types and sizes of companies;
- good corporate governance may also matter to shareholders in unlisted companies. While certain corporate governance issues are already addressed by company law provisions on private companies, many areas are not covered. The question is whether any EU action is needed on corporate governance in unlisted companies.

Interested parties are invited to submit their views on the suggestions set out in this Green Paper to reach the Commission by **22 July 2011 at the latest**. On the basis of the responses received, the Commission will take a decision on the next steps. Any future legislative or non-legislative proposal will be accompanied by an extensive impact assessment taking into account the need to avoid disproportionate administrative burden for companies.