

Frequently Asked Questions: Consultation on the EU corporate governance framework

What is corporate governance?

Corporate governance is about how companies are managed and controlled. It is also about the existing relationships between a company's management, its board, its shareholders and its stakeholders.

What are the existing rules/recommendations?

The corporate governance framework for listed companies¹ in the European Union is a combination of legislation and 'soft law' (recommendations² and corporate governance codes).

A corporate governance code presents essential recommendations for the management and supervision of listed companies and standards for good and responsible governance³.

While corporate governance codes are adopted at national level, the EU legislation on company reporting (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 its application on a 'comply or explain' basis. This means in practice that a company choosing to depart from a corporate governance code has to explain which parts of the corporate governance code it has departed from and why it has done so. Cf Annexe with relevant EU measures in the field of corporate governance.

Why is this consultation needed? What are the problems?

One of the lessons of the crisis was that corporate governance, mostly based on self-regulation, was not as effective as it could have been. Directors failed in their supervisory functions, as there was no effective challenge to the management in boardroom due to the phenomenon of group think.

¹ Companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State.

²For a list of EU measures in the field of corporate governance, see Annex- at the end of the memo.

³ A very complete list of existing corporate governance codes can be found under:

http://www.ecgi.org/codes/all_codes.php

There was also a lack of shareholder interest in holding the management accountable for their decisions and actions, enhanced by the fact that many of them hold their shares for only a short period of time (**the average holding period can be derived from share turnover velocity data available on www.world-exchanges.org**). This may contribute to poor management, in particular in companies with dispersed share-ownership.

There is also evidence of shortcomings in the application of the corporate governance codes when reporting on the 'comply or explain' basis. The information provided by companies is in general unsatisfactory and the oversight by monitoring bodies is insufficient⁴.

Is action at European level necessary? After all, have not a number of Member States already started to discuss their corporate governance codes?

More and more European businesses operate on a cross-border basis and for that reason the corporate governance framework at national level is growing in importance. In this respect, possible actions at EU level will complement the actions taken national level.

It is worth mentioning that in some Member States, stewardship codes for shareholders have been or are being developed. They are codes of conduct for shareholders and asset managers, which aim to enhance the quality of engagement between shareholders and companies and improve transparency on shareholder activity.

This development is welcomed because it facilitates a debate on shareholders' responsibilities and may have a positive effect on shareholder engagement and the management of companies. However, the expected effect of the development and adherence to such codes might be limited. For instance, the codes might not take away some of the underlying reasons for the lack of shareholder engagement, such as the short-termism of the financial markets (in recent decades, trading volumes and liquidity have increased, but at the same time, average shareholding periods have decreased).

What does the Green Paper cover?

The Green Paper focuses on three chapters: boards of directors⁵, shareholders and monitoring and enforcement of corporate governance codes.

The chapter on boards addresses means to tackle the phenomenon of group think in the boards of companies by improving their effective functioning and ensuring they are composed of a mixed group of people, e.g. by enhancing, gender diversity, a variety of professional backgrounds and skills as well as nationalities. It will also look at the functioning of boards, namely in terms of availability and time commitment of directors. Questions on risk management and directors' pay are also included.

⁴ See e.g. the study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, available at http://ec.europa.eu/internal_market/company/ecgforum/studies_en.htm

⁵ The term 'board' essentially refers to the supervisory role of directors. In a dual structure (or two-tier board system), this role generally falls to the supervisory board.

In the chapter on shareholders, the Green Paper addresses several underlying reasons for the lack of appropriate shareholder engagement, such as the short-termism of the financial markets (if we consider the fact that holding periods of shares has decreased over the last decades and the average holding period of shares is eight months⁶), problems arising from the principal-agent relationship between investors and their asset managers, conflicts of interests and difficulties with shareholder cooperation. The green paper seeks views on enhancing shareholders' involvement on corporate governance issues by encouraging them to take an interest in sustainable returns and longer term performance

Other issues covered in this chapter are: *proxy advisors* (i.e. firms providing services to shareholders, such as voting advice for general meetings), *minority shareholder protection* (i.e. to protect small shareholder against potential abuse by a controlling shareholder), *shareholder identification* (i.e. a mechanism to allow issuers to see who their shareholders are) and *employee share ownership* (i.e. schemes allowing employees to participate in the stock capital of the company where they are employed).

The last chapter focuses on ways to improve monitoring and enforcement of existing national corporate governance codes, focusing in particular on quality of information provided by companies and the oversight by monitoring bodies.

What are the objectives of the Green Paper?

The objective of the Green Paper is to have a broad debate on the issues raised. It allows all interested parties to see which areas the Commission has identified as relevant in the field of corporate governance. It is also an opportunity for everybody to express their views on the questions raised, and to provide any relevant material. Finally, the Green Paper allows to flag items the Commission has not considered so far.

How is this consultation different from the Commission's previous consultation on corporate governance in financial institutions?

This consultation looks at the corporate governance of companies at large. It is not focussing on financial institutions as the previous consultation (see [IP/10/656](#)). It is not so much a response to the financial crisis, but it reflects on the general functioning of corporate governance in Europe and possible ways forward. The Green Paper takes due account of the diversity of corporate structures in the various Member States.

⁶ Data from the World Federation of Exchanges: www.world-exchanges.org.

Why does it cover also non-financial institutions? They did not cause the crisis.

This Green Paper is not a response to the financial crisis. The Commission's analysis has shown, however, that corporate governance of companies in Europe may still leave room for improvement. As an example, there are still Member States where about half of the listed companies have no women on the board at all. For example, in Italy 70%, in Portugal 55%, in Austria 50% and in Poland 47% of listed companies have no women on the board⁷ Best performers are Denmark, Finland, Sweden, France, Germany and the EEA member Norway, where 90% or more companies have women on board. In the Nordic countries the share of women on boards oscillates between 18 and 33%. The European average is 12%. Worst performers are Italy: 3%, Portugal: 4% and Austria, Poland and Belgium with a female share of directors of each 8%.

The international diversity is also lagging behind in some countries in Poland 68% of listed companies have no foreign director on the board at all, in Italy this figure is 58% and in Spain 46%⁸. There is a need to have more long-term elements in the system as it currently stands.

How does the Green Paper fit with other Commission initiatives on corporate social responsibility?

Both corporate governance and corporate social responsibility are important to companies. While corporate governance concentrates more on internal processes and the functioning of the company, corporate social responsibility focuses on its relations with the broad range of external stakeholders and its social and environmental responsibilities.

The Commission's work on the corporate governance and on corporate social responsibility is complementary. In the field of corporate social responsibility, the Commission has recently conducted a consultation on the disclosure of non-financial information by companies⁹ and on country-by-country reporting¹⁰ (see [MEX/10/1026](http://ec.europa.eu/internal_market/consultations/2010/1026)) and will reflect on possible follow-up measures. The Commission also intends to publish this year a broader Communication on corporate social responsibility.

What are other regions in the world doing in this field?

The US Securities and Exchange Commission (SEC) is currently conducting a consultation on various aspects of the US proxy system (the system which organises shareholder voting). Concerns around proxy advisory firms are part of the consultation. In the Green Paper, the European Commission consults on issues related to proxy advisors in the EU.

⁷ According to Heidrick & Struggles' European Corporate Governance Report 2011, p.39.

⁸ According to Heidrick & Struggles' European Corporate Governance Report 2011, p.38.

⁹ http://ec.europa.eu/internal_market/consultations/2010/non-financial_reporting_en.htm

¹⁰ http://ec.europa.eu/internal_market/consultations/2010/financial-reporting_en.htm

What will be the follow-up to the public consultation? Will there be any legislative proposals?

The public consultation will take place from 5 April to 22 July 2011. The Commission will carefully examine all the replies to the consultation and issue a feedback statement summarising the results in autumn. On that basis a decision will be made whether legislative proposals are necessary. As usual they will only be tabled after a thorough impact assessment has been carried out.

Why is gender balance on boards important? Will the Commission introduce quotas?

Companies must have effective boards able to challenge management's decisions. It is extremely important to tackle the phenomenon of 'group think' which has been often observed in corporate boards. Having a more diverse board means having more diverse views, debates and challenges. Gender diversity is particularly important as women have different leadership styles and tend to ask more questions to management. Promoting women to boards can also contribute to increasing the pool of talent available for companies' highest positions.

Currently the proportion of women on boards of companies in the EU is on average 12%. It appears that unless action is taken, it will take another 50 years to attain a more balanced situation. Thus, it is necessary to consider possible means to reinforce gender balance on boards. Different measures can be envisaged, such as introduction of quotas, but also enhancing disclosure on diversity issues. The aim of the consultation is to gather stakeholders' views on the best ways forward.

What is the link with the Commission's strategy on gender equality?

The work on gender balance in economic leadership is complementary to the Green Paper adopted today. Under the strategy for promoting equality between men and women in Europe (see [IP/10/1149](#)), the Commission monitors progress on gender equality, in particular by collecting and disseminating comparable data at EU level through its database on women and men in decision-making.¹¹ By launching this consultation, the Commission now takes the opportunity to gather opinions on the best ways forward.

Does the Green Paper cover risk management issues?

Yes, it considers the board's duties in this field. It is crucial that the board ensures a proper oversight of the risk management processes. In order to be effective and consistent, any risk policy needs to be clearly 'set from the top', i.e. decided by the board of directors for the whole organisation. In each company, roles and responsibilities of all parties involved in the risk management processes need to be clearly defined: the board, the executive management and all operational staff.

Why does the Green Paper consult on directors' remuneration again?

Director's remuneration was also addressed in the Green Paper on corporate governance in financial institutions (see [IP/10/656](#)). A number of respondents to this consultation mentioned that they would welcome more transparency and a shareholder vote on remuneration.

¹¹ <http://ec.europa.eu/social/main.jsp?catId=764&langId=en>

Problems related to directors' remuneration, such as lack of transparency, shareholder involvement and incentives for long term value creation are not limited to financial institutions. The 2010 Commission report on directors' remuneration¹² showed that many Member States have not endorsed the recommendations. On the other hand, the report mentioned that there appears to be a growing tendency among Member States to legislate on disclosure of remuneration and the shareholders' vote.

The purpose of the consultation in this Green Paper is to gather more detailed feedback and for that reason, poses more detailed questions, in particular as regards transparency and the shareholders' vote.

Why does the Commission address shareholders' passivity and the short-termism of the financial markets? Are shareholders not free to make their own investment decisions?

The Commission recognises that not all investors need to actively engage with the companies they invest in. Moreover, investors are free to choose a short-term-oriented investment model without engagement. However, the increasing short-termism of the financial markets and the lack of appropriate shareholder engagement across sectors and markets are likely to have a negative impact on the management of companies. Shareholder oversight is one of the checks and balances in the corporate governance system and is an essential tool to hold management accountable for its decisions and actions. Therefore, the purpose of this consultation is to find possible ways to encourage the presence of a critical mass of shareholders, willing to take their engagement responsibilities seriously. In this Green Paper the Commission has identified different obstacles to shareholder engagement, which may need to be addressed further.

Why does the Green Paper cover proxy advisors, given that they do not have voting rights?

Proxy advisors (i.e. firms providing services to shareholders, such as voting advice for general meetings) have an influence on voting decisions made by shareholders, which in some case may be substantial. Institutional investors, which invest in many companies, might not have the time or resources to assess in detail how they should vote in the general meetings. So, they make use of the services of a proxy advisor, such as voting advice. Also, institutional investors rely more heavily on voting advice for their investments in foreign companies than for investments in their home markets. Given the influence proxy advisors have on shareholders' behaviour, the consultation also addresses the role of proxy advisors and some concerns with regard to their functioning, such as the methods applied with regard to the preparation of the advice and possible conflicts of interest.

¹² (COM (2010) 285) report on the application of recommendation 2009/385/EC

Annex with relevant EU measures in the field on corporate governance

- Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings, OJ L 224, 16.8.2006, p. 1–7.
- Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390, 31.12.2004, p. 38–57.
- Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, p. 17–24.
- Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ L 142, 30.4.2004, p. 12–23.
- Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC) OJ L 52, 25.2.2005, p. 51–63.
- Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC) OJ L 385, 29.12.2004, p. 55–59.
- Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (2009/385/EC), OJ L 120, 15.5.2009, p. 28–31.