

CORPORATE GOVERNANCE – HOW MUCH WILL CHANGE?

Summary: *Corporate governance reform has become a priority in the EU and globally. The European Commission adopted an Action Plan on Corporate Governance and Company Law which – once implemented – aims to reduce the risk of corporate scandals and remove barriers to a genuine Single Market for financial services. During the next five years the Commission will present a range of legislative and non-legislative proposals which are intended to improve shareholders right and to provide rules on corporate disclosure and transparency.*

1. Background

Corporate governance is now at the centre of the European and global political and regulatory debate. The interest stems from the recent series of high-profile corporate failures and scandals that have severely damaged investor confidence and call into question the efficiency of existing corporate governance rules. In the EU context the European Commission's corporate governance initiatives also aim to strengthen the Single Market by reinforcing cross-border shareholder rights and corporate disclosure practices.

In May 2003 the Commission adopted its Corporate Governance and Company Law Action Plan.¹ This contains a number of initiatives aimed at strengthening shareholders' rights, reinforcing protection for employees and creditors, and increasing the efficiency and competitiveness of European business. It also devotes special attention to a series of corporate governance initiatives aimed at boosting confidence in capital markets. The Action Plan should not be viewed in isolation. It complements a range of measures already introduced under the Financial Services Action Plan (1999-2004), most notably the Market Abuse Directive, the Transparency Obligations Directive and the Markets in Financial Instruments Directive. The Corporate Governance and Company Law Action Plan proposes a mix of legislative and non-legislative measures. It is based on a set of short (2003-2005), medium (2006-2008) and long-term (2009 onwards) priorities.

The Commission is presently engaged in the following initiatives:

- A Commission Recommendation on Directors' Remuneration.
- A Commission Recommendation on the role of non-executive directors.
- Amendments to the EU accounting directives (4th and 7th Company Law Directives) enhancing directors' responsibility for financial and key non-financial statements, introducing a disclosure regime for intra-group transactions (including for 'Special Purpose Vehicles'), and requiring an annual Corporate Governance Statement.
- A proposal for an 8th Company Law Directive on statutory audits.
- A consultation for a directive on cross-border 'shareholder rights' in listed companies.
- A Communication on 'Preventing and Combating Corporate and Financial Malpractice' (the 'Post-Parmalat' Communication).

Other medium- and long-term priorities, which the Commission intends to engage in during the life of this Parliament, are:

- A study on the concept of 'shareholder democracy'.
- A Communication on the role of institutional investors in corporate governance.
- A revised proposal for the 9th Company Law Directive on group relations.
- A European Corporate Governance Forum which would encourage the convergence and coordination of national corporate governance codes.
- A proposal for a Directive on directors' liability.
- A study on the disclosure regime for bearer shares and bonds.

¹ "Modernising Company Law and Enhancing Corporate Governance in the European Union: A Plan to Move Forward", COM (2003), 284 final, 21 May 2003.

2. Key issues

Balance between legislation, regulation and best practice

The European Union needs to find a balance between the benefits of new legislation against increased costs of compliance. Experience suggests that the mere threat of legislation in this area is a convenient catalyst to improve self-regulation and encourage best practice. The Commission aims at improving corporate governance practices in the EU by reinforcing disclosure, market transparency and the 'comply or explain' principle. Based on this approach, it will fall to financial markets, investors and the media to enforce compliance with the EU standards. Research has shown that companies which have introduced good corporate governance and auditing practices offer better returns on capital and hence have easier access to capital markets. This should create the right incentives for implementing better governance practices.

Harmonized rules versus national flexibility

During the Commission's public consultation on the Corporate Governance and Company Law Action Plan in late 2003 the majority of industry respondents expressed concern that EU corporate governance standards should not become too prescriptive. In particular, the consultation confirmed a lack of support for a harmonized European Corporate Governance Code. In its Resolution on the Action Plan the European Parliament shared the view that a common code would simply add an additional layer to existing international standards (such as the OECD standards on corporate governance) and national member state codes.² The Commission also supports this position. While some industry representatives question the reasons for any EU activism in the field of corporate governance, the majority of industry respondents supports the Commission's emphasis on high-level European principles and rules, rather than detailed legislation. This gives member states a maximum degree of flexibility in implementing the rules. In some member states this might mean amending national legislation, in others changes to national codes which are policed by the industry itself. Flexibility in national implementation does not rule out the possibility of national practices converging over time. The Commission is planning to create a European Corporate Governance Forum that would establish a dialogue between national experts, possibly leading to greater convergence between national corporate governance codes.

The wider EU Company Law agenda

In its Resolution on the Action Plan, the European Parliament argued that in preparing proposals the Commission should take into account the EU's wider company law reform agenda. The Action Plan commits the Commission to a number of proposals for new company law directives.³ Other important areas that might influence the EU debate on corporate governance are the participation of workers, and the work on Corporate Social Responsibility standards. The Commission has stressed that these issues should not prevent the EU from implementing its narrower corporate governance objectives.

The quality of consultation

When launching its Action Plan the Commission conducted an extensive public consultation. Since then the track record has been mixed. The six week multiple choice style consultation on the importance of the responsibility of directors for financial statements and related issues was particularly unsatisfactory. Deadlines may have been achieved at the expense of the quality of regulation. Other more recent consultations by the Commission (for example on shareholders' rights) have been more encouraging.

Consistency between EU and US standards

In the wake of ENRON and WorldCom, the US authorities implemented the Sarbanes-Oxley Act in July 2002. This far-reaching piece of legislation has had an impact on everything from conflicts of interest

² European Parliament Resolution, 21 April 2004.

³ The Company Law aspects of the Action Plan include proposals on cross-border mergers, the transfer of headquarters, and the capital maintenance regime for limited public liability companies.

between corporate business and investment research to enhanced oversight of auditors. The extraterritorial effects of the Sarbanes-Oxley Act are a concern to the Commission. At the same time, the EU is now in the process of tackling many of the same issues. Recognizing the danger of overlapping and inconsistent rules between the EU and US, the European Commission and US authorities launched a transatlantic corporate governance dialogue in July 2004. This dialogue acknowledges that corporate governance issues are no longer national, but global in scope. Unless the Commission and the USA can find pragmatic solutions on the equivalence of rules and regulations differences in corporate governance practices could created serious barriers to global investment.

Conclusions

Corporate governance reform cannot be an end in itself. The EU should deliver a competitive and principled corporate governance framework which enables companies and investors to manage inherent risks while promoting a Single Market for financial services.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or the Secretariat.

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