Corporate Governance Reforms in the EU

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Economic crises often lead to law reform efforts being aimed at strengthening existing legal and other regulatory measures that were exposed as deficient by the crisis. These reactive reforms inevitably are more attuned to fighting 'the last war' than new market crises that may emerge, as they often simply seek to defuse the crisis and rarely seek to bring about fundamental changes. Such deeper changes cannot occur overnight and require a longer term effort to reorient business and legal cultures, something that corporate reformers often do not have the stamina to pursue.

Often, such reactive and sometimes populist reform measures are found by industry to be too harsh and are then diluted as a result, as what occurred following the Sarbanes-Oxley Act of 2002 passed in response to the collapse of Enron. The 1999 repeal of the Glass-Steagal Act of 1932 (which emerged from the financial crisis of the Great Depression years) might be seen as in the same category. Regrettably, such relaxations of earlier reforms can contribute to the next crisis.

The recent global financial crisis (GFC) again exposed weaknesses in our legal and regulatory frameworks for dealing with market abuses and regulatory failures. This crisis arose out of an economic boom fuelled by the growth of large multi-function investment banks (after the repeal of Glass-Steagal) that promoted the use of distorted incentives and poorly understood securities. The watering down of Sarbanes-Oxley-type reforms that were passed after the collapse of Enron also increased risks in markets. This sub-prime mortgage boom had been supported by a modest to non-existent system of corporate regulation sustained by the belief that market would be able to regulate itself.

As a consequence of the GFC, the European Commission, in April 2011, released a Green Paper entitled *The EU Corporate Governance Framework*. This follows and builds upon the Commission's more narrowly focussed 2010 Green Paper on *Corporate Governance in Financial Institutions*.

This new consultation (which is open until 22 July 2011) is looking at a wider range of companies and not just financial institutions and echoes similar debates in the UK, which ultimately saw the revision and renaming of the main corporate governance code, now known as the UK Code of Corporate Governance (2010). It also saw the upgrading of a previous industry code into the new UK Stewardship Code, which encourages more shareholder engagement by institutional shareholders. Both of these Codes continue to rely upon the old 'comply-or-explain' approach (which was found wanting during the financial crisis) and have sought to undermine efforts to introduce more stringent legislative measures.

In recommending the new UK Stewardship Code in 2009, Sir David Walker had argued that fund managers should have a duty of stewardship and a commitment to their stewardship obligations but that this should be subject to the terms of their respective mandates; where they fail to do this, they should explain their investment approach. This Code seems a very limited outcome from a major economic crisis. It rests upon a narrow shareholder primacy view, which inevitably limits the options that are available when seeking to modify a governance framework.

In this context, the Commission's 2011 public consultation Green Paper seeks to evaluate the effectiveness of the existing corporate governance framework more generally in the light of the failures experienced during the financial crisis. The Commission considers that three subjects are 'at the heart of good corporate governance': the board of directors, shareholder involvement, and the monitoring and enforcement of existing national corporate governance codes through the use of the 'comply-or-explain' mechanism.

It is surpassing that the Commission only considered that these three subjects were fundamental to good corporate governance. The Paper seems to mimic recent British corporate governance reforms, which have taken a very narrow view of the nature of the problem and avoided any real consideration of possible reforms. A much broader approach is actually called for as the shareholder primacy approach inherent in the Commission's Paper has been

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challenged by the rise of stakeholder concerns. In 2006, the UK enacted a new Companies Act creating a modest commitment to stakeholder principles (in the form of section 172 of this Act).

Also, leaving enforcement to the optional comply-or-explain mechanisms may let companies off the hook and avoid looking for more nuanced internal controls linked to external governance mechanisms and the internal corporate culture of the enterprise. Contemporary corporate-governance thinking has called for a wider approach to corporate governance, which links the broader range of internal and external stakeholders so as to compensate for the weaknesses of the board as an oversight body.

The Green Paper asks whether there should be a clearer division between the functions and duties of the company chairman and its chief executive officer (CEO) and to ensure that the composition of the board is looked at. This is a good start; however, the focus has been on achieving greater professional diversity, international diversity, and gender diversity on the board. These are worthy, but the key problem, especially in larger companies and in listed companies, is to ensure that there are skills around the board table that are appropriate to the particular company's circumstances. Although greater diversity is laudable, diversity should not be the primary aim. Too many boards draw their members from like-minded pools and the tendency for 'group think', which the Green Paper acknowledges should be treated more seriously.

In addition to a director's skills and experience, it is important to ensure that they have the information and temperament to be prepared to challenge an overbearing CEO. The absence of such qualities was found to be a major problem in the lead-up to the recent financial crisis. The Green Paper also correctly notes that it is important that board members have the time to participate effectively as directors; time needs to be linked with the access to adequate information (especially for outside or independent directors) and access to expert advice to allow them to be more effective board members.

The Green Paper recognizes the value of external evaluations of board performance and asks whether companies should be encouraged to conduct regular external evaluations. The performance of directors should be linked to their remuneration. The Paper notes that inadequate remuneration policies 'may lead to unjustified transfers of value from companies and their shareholders and other stakeholders to executives'. This at least mentions the importance of other stakeholders; some suggest that other stakeholders, such as employees, should also serve on company remuneration committees.

Executive remuneration is probably the most controversial corporate governance issue facing large companies. We have increasingly seen calls for a greater 'say on pay' on the part of shareholders, and legislative reforms to strengthen the position of other stakeholders in regard to this matter have been slow. The 2010 Dodd-Frank Act in the USA is one recent example of steps in this regard, with the introduction of an advisory resolution for shareholders in financial institutions to have a say on pay. Similar provisions are to be found in other jurisdictions.

Executive remuneration calls for more detailed questions being asked than those found in the consultation, especially given the way in which distorted incentives have led to short termism in executive action in many sectors. The European Commission should move beyond merely asking whether disclosure of remuneration policies and individual remuneration should be mandatory; likewise, asking whether shareholders should be allowed to vote on these matters is a good start; it should also be considering wider stakeholder involvement.

The Green Paper also asks whether company risk management strategies have been adequately considered by the board and notes that the company's appetite for risk should be 'set at the top', by which it means directors. A company's risk profile is also a matter for other stakeholders in the company, such as its employees, creditors, and shareholders. Consistent with recent reforms in the UK, the Green Paper also seeks to promote greater shareholder engagement with companies. The 2010 Green Paper found that the financial crisis saw inadequate efforts by shareholders to restrain excessive risk-taking by financial institutions. This relatively docile approach will be difficult to change in widely dispersed shareholding companies but may have more success in smaller companies where individual shareholdings are relatively larger.

Financial markets are almost inevitably short term in their focus, and efforts to encourage institutional investors to run against this trend will be very hard to sell, especially in listed companies where share prices may fluctuate considerably. It is doubtful whether a UK-style Stakeholder Code is the way forward. Encouraging long-term success is a part of recent reforms in the UK, but this goal faces massive problems in highly financialized companies that depend considerably on derivatives trading and on ensuring that their stock price is kept high.

However, the Commission is correct in asking whether institutional asset managers can be more effective in their engagement with their investee companies. Employee share ownership may be another way of fostering greater long-term thinking among shareholders. Institutional asset managers may need assistance in being able to handle company agendas, and it is suggested that proxy advisers could assist here. Greater transparency in the identification of shareholders is another important issue if there is to be adequate shareholder engagement and dialogue with companies. The Green Paper also looks at minority shareholder protection, especially in companies where there is a controlling shareholder (where a comply-or-explain regime may not be helpful).

Directive 2006/46/EC sought to promote the use of national corporate governance codes and urged listed companies to report on the application of these codes on a comply-or-explain basis. The 2011 Green Paper briefly seeks to review the effectiveness of this method of implementing governance codes in the light of research that has suggested that the quality of information provided by companies was unsatisfactory and that 'in many Member States there is insufficient monitoring of the application of the codes'. Much can be done to improve the reliability and usefulness of these kinds of disclosures, and the involvement of other stakeholders, such as employees, may be way of moving in this direction.

There are many good ideas in this short Green Paper. However, consideration might have been given to a broader range of ideas on such matters as executive remuneration, board decision-making, and stakeholder engagement. By framing issues so narrowly, there is a danger that the European model of corporate governance that emerges will also be somewhat narrow and will only seek to have regard to a number of populist issues, such as diversity management and shareholder engagement. A wider stakeholder approach to corporate governance might have raised a broader range of questions.