Synthesis of the comments on the Consultation Document of the Services of the Internal Market Directorate-General

"Recommendation on the Role of (Independent) Non-Executive or Supervisory Directors"

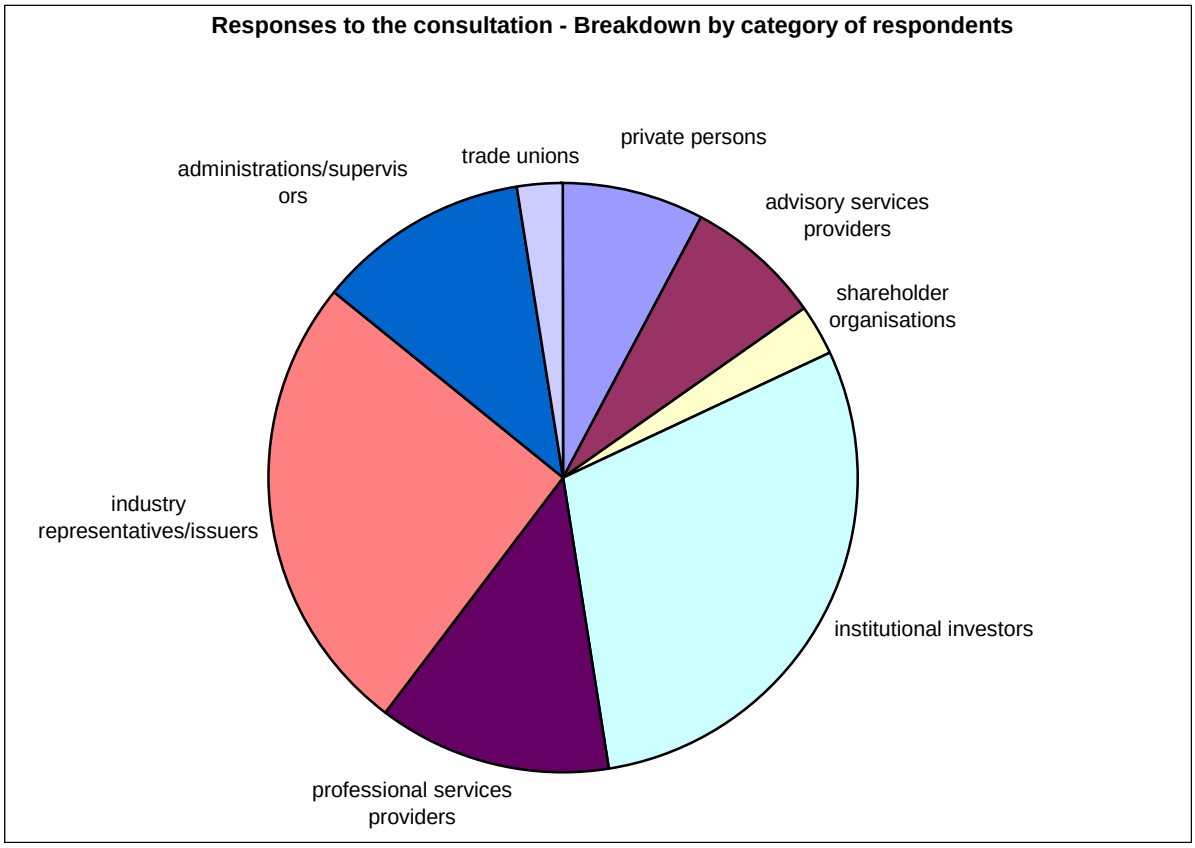
A Working Document of DG Internal Market

September 2004

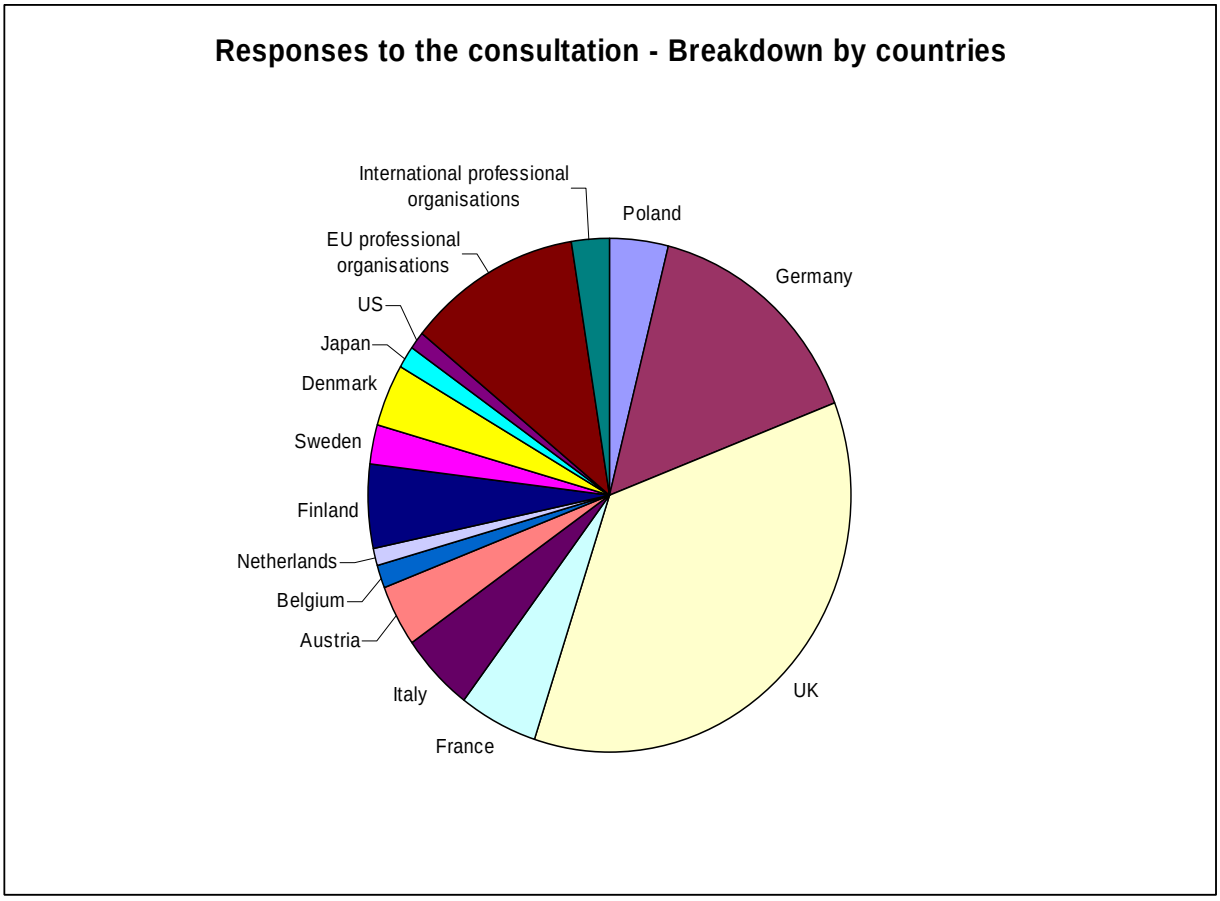
1. Introduction

On 5 May 2004, the Services of the Internal Market Directorate-General (hereinafter IMDG), in the context of the preparation of the forthcoming Recommendation on the role of non-executive or supervisory directors (hereinafter Recommendation), launched a public consultation on a document entitled “Recommendation on the role of (independent) non-executive or supervisory directors” (hereinafter Document) in order to collect the views of interested parties as to the possible structure and content of the Recommendation.

A total of 78 contributions were received, primarily from institutional investors, issuers and industry representatives, professional services providers (auditors, accountants, lawyers, company directors), national administrations and financial services supervisory authorities. Several advisory services providers (think tanks, research institutes, CG consultancies), private persons, shareholder organisations, and trade unions also submitted their comments.



There was a wide geographical coverage in terms of responses received, with respondents from 13 countries, including 11 EU Member States. A significant number of replies were received from representative organisations at EU and international level.



This report seeks to provide a survey of the comments received by the Commission services. It provides a synthesis of the positions most frequently advanced by respondents vis-à-vis the issues raised in the Document. Since respondents generally concentrated their observations on some specific points, the report, while broadly following the structure of the Document, will cover in particular those parts that were mainly addressed by respondents.

The report does not include statistical data on the responses provided; rather, it seeks to present a qualitative assessment of the responses received. In particular, the level of support for, or opposition to, the specific policy orientations presented in the Document has been evaluated by the Commission services not only according to the sheer number of respondents, but also taking into consideration the degree of representativeness of the respondents.

2. General observations made by respondents

Most of the comments concentrated on providing general observations on two points: the main characteristics of the Recommendation (as anticipated in the Document), and the definition of independent directors.

2.1 General positions on the Document

A) A majority of respondents expressed general support for the proposed initiative and were also generally supportive of the aims of the Document. Particular support was expressed in relation to: 1) the Commission's intention to adopt a Recommendation aimed at inviting Member States to introduce in their national framework, on a comply-or-explain basis at the minimum, a set of detailed principles to be used by listed companies, and 2) the flexibility offered to Member States which, although such principles should obviously be inspired by the minimum standards defined in the Recommendation, would be free to take into account material circumstances particular to them. Although expressing reserves on some specific points of the Document, these respondents appreciated that the Document leaves space for flexibility at national level. For instance, in approving that the Recommendation is aimed at Member States, they remarked that in this way Member States will be left with the option of whether to decide in favour of binding legal provisions or in favour of non-binding self-regulation.

More specifically, it is possible to divide these answers in two sub-categories:

A1) Some of these respondents encouraged the Commission to proceed even further, for instance in terms of a more detailed text or a text which recommends the implementation of minimum standards by Member States through binding regulatory measures.

A2) Other respondents, while expressing their agreement on the general structure of the Document, suggested modifying specific points of the Recommendation, with particular reference to the scope of the Recommendation, the board composition, and board committees (see applicable paragraphs later on in this report).

B) Other respondents objected to some specific parts of the Document as unsuitable for their system. This was typically the case for respondents who found the proposed definition of independence unsuitable to their national systems and proposed substantial changes to this definition.

C) A non-negligible minority of respondents had stronger objections, expressing the concern that the Recommendation would actually ultimately become an EU corporate governance code.

C1) Within this category, a few respondents objected to having any EU instrument on the independence of directors.

C2) Other respondents deemed the proposed Recommendation too detailed and tantamount to uniform corporate governance legislation, while an intervention by the Commission should be limited to very general principles, for instance those established by the OECD in its Principles for Corporate Governance. According to this last sub-category of respondents, because of institutional and legal differences across EU countries, it is not possible to reach a consensus on supranational rules in this area. Thus, according to them, it should be left to Member States to take care of corporate governance codes. Several of these respondents remarked that the proposed Recommendation referred to in the Document would have de facto a

legislative nature, either because it would be followed at some point in time by a Directive or because of the sheer fact that a Recommendation coming from the European Commission would induce Member States to adhere to its contents as if they were of a legislative nature.

2.2 Comments on the definition of independent directors given in the Document

A large number of respondents expressed their general appreciation of the fact that the Document puts forward a definition of independent directors, and moreover sets out a list of criteria that guide the interpretation of "independence".

Within this category, several submissions even asked for more stringent requirements, for instance in questioning the choice made by the Document of leaving it to the (supervisory) board to determine what constitutes independence of some of its members. Since (supervisory) boards are often controlled in Europe by large block holders, interpreting directors' independence should be a fundamental shareholder right which should not be submitted to the discretion of (supervisory) boards.

Other respondents asked for a more detailed definition of independence, which for instance would allow the consideration of relationships with significant shareholders, and not just controlling shareholders, as a threat to independence; or which would introduce more independence criteria, such as the lack of any criminal conviction for bankruptcy, fraud, false accounting and other criminal offences or not being recipient of any pension funded by the company nor any deferred or contingent remuneration or un-exercised executive share option.

The following were also suggested : the application of a shorter term of one year for the re-election of board members; specifying that an independent director should not have any significant business relationship with the company within the last three years and not just one year; looking not just at other business commitments of non-executive directors, but also to any other (social) activity (academic involvement, charities, etc.)

On the other hand, there were some remarks on the concept of independence which however do not really put into question the approach chosen by the Commission, for instance the suggestion that having a financial interest in the company in the form of share ownership is not incompatible with an independent status; or the suggestion that a long period of service on board does not necessarily undermine independence of judgment.

While not necessarily disagreeing with the definition of independence given in the Document, a significant number of respondents remarked that the Recommendation should be limited to a general definition of independence, leaving the definition of more detailed requirements to national codes.

A number of respondents asked for a less rigid definition of independence, for instance concerning the five-year term, suggested by the Document, before a former

company executive can be recognised as independent, or the time limit for service on a board by independent directors (as opposed to other respondents who asked for a shorter term than the 12-year one suggested in the Document), or the fact that independent board members should not have material additional sources of remuneration. More importantly, they suggested that independent directors should just be independent simply from company and management and not from major shareholders.

Other respondents expressed fundamental objections to the definition of independence. In particular, some respondents remarked that they foresaw serious problems in meeting independence requirements in Member States where national legislation mandates the presence of employee representatives on supervisory boards of the largest companies. Some of these respondents also objected to the fact that the Document does not recognise as independent former CEOs, or representatives from banks that have a business relationship with the company, from companies belonging to the same group, and from competing companies.

Finally, very few respondents objected to the concept of independence *per se*.

3. Addressees and the comply-or-explain provision

According to a large number of respondents, the proposal to address the Recommendation to Member States exclusively and to promote a "comply-or-explain" approach allows Member States to introduce in their national framework a set of detailed principles to be used by listed companies with due regard to local practices. In particular, they appreciated that the "comply-or-explain" approach will allow individual companies to be flexible in what they consider appropriate for their own circumstances, leaving companies the possibility of providing explanations as to why they decided to depart from the best practice guidelines. Two respondents even asked that explanations be substantial, specific and reasoned. Furthermore, four of these respondents asked for an enforcing mechanism or for an altogether stricter rule, since the comply-or-explain approach may not work in countries with a less mature stock market, where other mechanisms for enforcement should also be used.

Some respondents did not agree that shareholders should have the right to ask for any additional information at the general meeting, lest this could enable single pressure groups to disrupt and prolong annual general meetings.

4. Scope

A large number of respondents (and the overwhelming majority of those who expressed an opinion on this subject) were favourable to the approach taken in the proposed text, in which it is proposed that the Recommendation will invite Member States to adopt measures which would be applicable to listed companies, specifying that Member States will not be prevented from extending all or some of the standards set out to all or some categories of non-listed companies. These respondents observed that, in non-listed companies, the principal-agent monitoring problem

between shareholders and management is generally solved by having representatives from shareholders sit on the board. Moreover, particularly when it comes to small family-owned businesses, the creation of committees is often deemed unnecessary. On the other hand, several of these respondents were in favour of extending the scope of the Recommendation also to non-listed companies such as widely-held companies and pension funds.

Several respondents suggested that the Recommendation should be applied to all companies listed in EU Member States irrespective of their place of incorporation. They argued that restoring confidence in financial markets requires that the market to be protected must be identified on the basis of the venue where the financial instruments are traded. Moreover, they remarked that the comply-or-explain provision provides the necessary flexibility to adapt to differing rules imposed by the legislation of the place of incorporation. According to some of these respondents, this argument is further supported by the fact that the US Sarbanes-Oxley regime is far less flexible but is correspondingly applied and that eventual difficulties can be handled through the Trans-Atlantic Dialogue, while others observed that the Recommendation should be applied to all companies listed in the EU, provided there is no conflict with the home country legislation.

Other respondents were in favour of the proposed text, and specified that the Recommendation should not cover non-EU companies listed in the EU: to overlay a home country's corporate governance regime with the EU model could act as a disincentive to seeking an EU listing. Among this category of respondents, a few observed that, with respect to EU companies, it is the Member State in which the company is listed (rather than the Member State in which it has its registered office) where a public interest arises in ensuring that appropriate corporate governance measures are adopted.

5. Board composition

A substantial proportion of respondents (and the overwhelming majority of those who expressed an opinion on this subject) wanted the Recommendation to advise for the separation of the functions of CEO and Chairman of the board, or at least that, if the two roles are combined, boards should have a senior independent director to provide "checks and balances" in the boardroom in respect of issues where the Chairman might be conflicted. Moreover, the "comply-or-explain" approach would give the possibility - for those cases where there are legitimate reasons for the combination of the two functions - to provide a fully public explanation to justify the practice. Concerning the two-tier model, some of the same respondents expressed the opinion that a departing CEO should not immediately become Chairman of the supervisory board, as he may be unable to exercise objective oversight.

With respect to the total number of independent directors, several respondents asked for a majority of independent (supervisory) directors on the board, or in any case for a number of independent (supervisory) directors which should reflect the proportion of equity investors, that is of the free float in a given company. Such a measure is deemed necessary to allow a significant reduction in potential conflicts of interest, with a view to better protecting minority shareholders.

Several respondents also asked for a broader emphasis on the role of independent directors, who should not only deal with risks and conflicts of interest, but also contribute to company strategy.

6. Board committees

A large number of respondents (and the large majority of those who expressed an opinion on this subject) agreed with the Document on the need for the future Recommendation to present as best practice the creation of nomination, remuneration and audit committees within the (supervisory) board, which should make recommendations aimed at preparing the decisions to be taken by the (supervisory) board itself, and that companies would remain free to decide any arrangements which they see appropriate in their particular circumstances. Some of these respondents put particular stress on the need for the future Recommendation to avoid being excessively prescriptive in this field.

A number of respondents suggested more flexibility for smaller listed companies in their board arrangements.

Those respondents who objected to independence requirements also demonstrated their opposition to the principle of establishing board committees with a majority of independent members. They observed that it is not necessary to require the creation of the three committees in two-tier board systems since their functions are in these systems adequately fulfilled by the separation (in terms of structure) of the management board from the supervisory board. According to some of these respondents, even though in some cases committees are deemed to be helpful, companies should be left completely free to decide whether to have committees, and which ones. Moreover, companies should not be required or expected to explain why they do not make recourse to committees. With particular reference to audit committees, some of these respondents specified that companies should be allowed to organise their internal control systems according to their needs.

Some respondents indicated as best practice the disclosure of committees' opinions to shareholders, and supported the idea that the chairman of each committee should be available to respond to questions from shareholders at the annual general meeting. The enhanced transparency of board committee deliberations could induce executive directors to adequately take into account the positions of board committees. However, two respondents voiced their opinion against this possibility, lest it undermines the concept of the unitary board and of collective responsibility.

6.1 Nomination committee

A substantial number of respondents (and the overwhelming majority of those who expressed an opinion on this subject) did not agree on the need for requiring that the CEO and/or other executive directors be included in the nomination committee, or at least insisted that the committee be chaired by a non-executive (or supervisory) independent director. According to these respondents, it is necessary to prevent executive directors from influencing the choice of other board members who will in

turn be controlling or supervising their actions. For some of these respondents, though, the CEO should indeed be consulted by the committee.

6.2 Remuneration committee

Given the sensitive role performed by the remuneration committee, several respondents asked for the remuneration committee to be formed entirely of non-executive (or supervisory) independent directors.

6.3 Audit committee

Several respondents considered that, because of the significance of the audit committee's work, it should be formed entirely of non executive (or supervisory) independent directors.

A large number of respondents agreed with the Document on the need for audit committee members to be selected keeping in mind the need for some financial literacy, in order for directors to be able to ensure supervision over issuers' financial and accounting practices. On the other hand, three respondents objected to the necessity for all members of the audit committee to understand financial statements: according to them, audit committee members should rather have an understanding of how their business operates.

According to several respondents, companies should be left free to decide whether to have an internal audit function and/or whether to give the audit committee a supervisory role vis-à-vis the internal audit function (which in some countries is rather reporting to the managerial board).

Finally, a few respondents explicitly approved the provision set out in the Document concerning the possibility for employees to report alleged irregularities to the chairman of the (supervisory) board through the audit committee, while one of them expressed a preference for the audit committee itself to be the addressee of such complaints. Conversely, two respondents expressed their preference that no whistleblowing procedures be in place, so as not to encourage spying and denunciation.

7. Conclusion

DG MARKT wishes to thank all respondents for their valuable and high quality contributions.

Although it has proved impossible to record in this Document all details of the suggestions expressed, the Commission will bear them in mind when working on the future Recommendation.

DG MARKT apologises if any of the arguments advanced have not been reflected precisely enough due to possible translation errors or other reasons.