



EUROPEAN COMMISSION

Internal Market Directorate General

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Recommendation on the role of (independent) non-executive or supervisory directors

Consultation document of the Services of the Internal Market Directorate General

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Preliminary remark

This document has been drafted by the services of the Internal Market Directorate General in the context of its preparation of the Recommendation on the role of (independent) non-executive or supervisory directors. It provides initial indications of the views of the services of DG Internal Market as to the possible structure and content of this Recommendation. These preliminary orientations are without prejudice to any future decisions by the European Commission in finalising its Recommendation.

INTRODUCTION

In its Action Plan¹ adopted on 21 May 2003, the Commission announced measures to modernise company law and enhance corporate governance in the European Union. With the objective of modernising the board of directors, the Commission's position as to the role of non-executive or supervisory directors was stated as follows:

*"In key areas where executive directors clearly have **conflicts of interest** (i.e. remuneration of directors, and supervision of the audit of the company's accounts), decisions in listed companies should be made exclusively by **non-executive or supervisory directors** who are in the majority independent. With respect to the nomination of directors for appointment by the body competent under national company law, the responsibility for identifying candidates to fill board vacancies should in principle be entrusted to a group composed mainly of executive directors, since executive directors can usefully bring their deep knowledge of the challenges facing the company and of the skills and experience of the human resources grown up within the company. Non-executive directors should, nonetheless, also be included and specific safeguards should be put in place to deal with conflicts of interest when they arise, for example when a decision has to be made on the reappointment of a director.*

These requirements should be enforced by Member States at least on a "comply or explain" basis. Certain minimum standards of what cannot be considered to be independent should be established at EU level. With a view to fostering a concrete and active role for non-executive or supervisory directors, particular attention will be paid to the issue of the number of mandates that may be held concurrently. Moreover, the impact of interlocking directorships on the independence of directors should be properly addressed in the minimum standards to be established.

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

The Commission regards these measures as key to the restoration of confidence in the markets, and therefore intends to adopt a Commission Recommendation to this effect in the short term.

*Such a Recommendation will define minimum standards applicable to the creation, composition and role of the **nomination, remuneration and audit committees**. In view of the recent accounting scandals, special emphasis will be placed on the audit committee (or equivalent body), with a view to fostering the key role it should play in supervising the audit function, both in its external aspects (selecting the external auditor for appointment by shareholders, monitoring the relationship with the external auditor including non-audit fees if any) and its internal aspects (reviewing the accounting policies, and monitoring the internal audit procedures and the company's risk management system).*

(Footnote 18 : In developing the minimum standards applicable to the audit committee, appropriate attention will be paid to a) the access it must have to the relevant information (there might be a scope for specific consideration of the need for greater legal protection for whistleblowers) and b) the extent to which transparency on its activities is desirable.)"

The services of the Internal Market Directorate General have decided to set up an open consultation process on the future Commission Recommendation.

The present Consultation Document on the role of (independent) non-executive or supervisory directors outlines the orientations envisaged for the forthcoming Recommendation, with respect to both its form and its content. It builds on the approach presented in the Action Plan, and seeks to properly take into account the comments received on the public consultation organised on the Action Plan as a whole.

Adoption of the forthcoming Recommendation is scheduled for early Autumn 2004.

Responses to this consultative paper should be concise. Because of the tight timing for adoption of the Recommendation, they should be provided no later than 4 June 2004. They should be sent to DG MARKT G3, European Commission, B-1049 Brussels. Responses may also be sent by e-mail to Markt-COMPLAW@cec.eu.int.

Unless an explicit request is made for confidential treatment, your contribution may be made public.

1. ORIENTATIONS FOR THE COMMISSION'S RECOMMENDATION: THE FORM

1.1. Legal basis

Most of the initiatives taken at EU level in the area of company law have been based on **Article 44 (2) g (ex 54) of the Treaty** establishing the European Community. This Article, which appears in the Chapter devoted to the right of establishment, requires the European institutions to attain freedom of establishment, *“by co-ordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 48 (ex 58), with a view to making such safeguards equivalent throughout the Community”*.

Although the ultimate objective of the forthcoming Recommendation is precisely to enhance the protection of the interests of shareholders and third parties, Article 44 cannot be considered as an appropriate legal basis since it only foresees the adoption of directives. The legal basis for the Recommendation will then be Article 211 of the EC Treaty, which gives the Commission a general power to formulate recommendations on matters dealt with in the Treaty, either where it expressly so provides or where the Commission believes that it is necessary to do so.

1.2. Addressees

Addressees of the recommendations adopted by the Commission are either Member States or private actors (referred to by the definition of an appropriate category of actors, or even identified individually). In some cases, recommendations are addressed to both Member States and private actors.

In view of this, it could be envisaged that the forthcoming Recommendation on the role of non-executive or supervisory directors should be addressed to listed companies. It is proposed not to do that, for the following reasons:

- (1) The intention of the Commission is not, as has repeatedly been stressed, to produce a European corporate governance code. The forthcoming Recommendation should not be viewed, neither because of its form nor because of its contents, as a set of detailed principles designated for direct use by listed companies. The Recommendation actually aims 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; such principles should obviously be inspired from the minimum standards defined in the Recommendation, but Member States would be free to take into account material circumstances particular to them.
- (2) Secondly, and equally importantly, Member States should be free, when implementing the Recommendation, to decide to introduce in their national framework binding provisions where appropriate. Moreover, some of the minimum standards to be defined in the

Recommendation are today already included in national legal or regulatory provisions.

It is therefore proposed to address the Recommendation to Member States exclusively.

1.3. The Comply or Explain Approach

Many corporate governance codes adopted in Member States tend to rely on disclosure to encourage compliance, based on the “comply or explain” approach: listed companies are invited to disclose whether they comply with the code and to explain any deviations.

This approach is a means of encouraging implementation of specific corporate governance standards without prescribing actual practices. Yet it recognises that disclosure alone can have a significant coercive effect: to avoid lengthy explanation, companies may consider compliance except as to those few points on which they believe they have strong justification for deviation.

The Recommendation would therefore invite Member States to introduce in their national framework, on a “comply or explain” basis at the minimum, a set of detailed principles – inspired by the minimum standards presented in the Recommendation - to be used by listed companies. Member States would be free to use the legal vehicle (company law, securities law, listing rules...) best suited to their environment, but the ultimate goal should be at the minimum to require listed companies to disclose whether they comply with the detailed principles adopted by an appropriate body at national level and to explain any deviations.

Under this “comply or explain” approach, a listed company should be required to specify annually the principles with which it has not complied (and, in the case of principles whose requirements are of a continuing nature, for what part of the accounting period such non-compliance occurred), and explain the extent of - and the reasons for - any material non-compliance. This would enable companies to reflect sector and enterprise-specific requirements, and the markets to assess the explanations and justifications provided. Every shareholder should have the right to request any additional necessary information at the general annual meeting.

Member States would be invited to implement the Recommendation at the minimum a) on a “comply or explain” basis, and b) with respect to the companies incorporated in that Member State and listed in the EU. As a consequence, Member States would be completely free:

- to decide to go further than the “comply or explain” approach on the minimum standards presented in the Recommendation, introducing or maintaining in their national framework any binding provisions deemed appropriate;
- to decide to extend all or part of the provisions, which are adopted to implement the minimum standards presented in the Recommendation, to non-listed companies incorporated in that Member State.

1.4. Implementation and follow-up

In view of the importance attached to the role of non-executive or supervisory directors with respect to the restoration of confidence, it appears desirable for the Commission to follow up closely the progress of implementation in Member States. It is therefore proposed to include in the Recommendation the following provisions:

- Member States are invited to inform the Commission by 31 December 2005 of the main steps taken pursuant to the present Recommendation, and to notify the Commission of any subsequent changes thereto;
- On the basis of the measures adopted in the Member States, the Commission will consider in the course of 2006 whether there is a need for any further action at Community level.

2. ORIENTATIONS FOR THE COMMISSION'S RECOMMENDATION: THE SUBSTANCE

2.1. Scope

2.1.1. Listed companies – Non listed companies

Fostering a proper role for non-executive or supervisory directors is one of the key measures aiming at restoring confidence in the financial markets. It is therefore proposed that the Recommendation should invite Member States to adopt measures which would be applicable to listed companies. Listed companies would be defined as companies whose securities are admitted to trading on a regulated market within the meaning of Council Directive 93/22/EEC in one or more Member States.

We nevertheless share the view that some features of what is considered to be best practice for the corporate governance of listed companies could prove to be beneficial also to other companies. The Recommendation should be drafted in such a way that Member States are not prevented from extending all or some of the standards set out to all or some categories of non-listed companies.

2.1.2. EU companies – Other companies

The Recommendation will invite Member States to adopt measures aimed fundamentally at influencing the way in which listed companies are organised. Since this objective goes much further than the simple provision of information, it is not considered appropriate to cover non-EU companies (listed in the EU), which have to comply with their domestic laws and regulations. The Recommendation would therefore invite each Member State to adopt measures which would be applicable to companies (listed in the EU) having their registered office in that Member State.

2.2. The need for some board committees

2.2.1. Two systems of board structure

In the EU, companies have typically either a one-tier board or a two-tier board (in some Member States, companies have the choice between both systems). In the first system, the “administrative board” is composed of a series of directors who are engaged in the daily management of the company (executive directors) and other directors who aren’t (non-executive directors). In the second system, a “managing board” is composed of the directors engaged in the daily management of the company (managing directors), whereas a distinct “supervisory board” (composed of supervisory directors) is responsible for overseeing the activity of the managing directors.

Independently from the formal structure present in any company, the protection of the interests of all shareholders and third parties makes it necessary for the management function to be submitted to an effective and sufficiently independent oversight function. In companies with a dispersed ownership, the primary concern is about how to make managers accountable to weak shareholders. In companies with controlling shareholders, the focus is rather on how to make sure that the company will be run in a way that properly takes into account the interests of minority shareholders.

Making sure that the management function will be submitted to an effective and sufficiently independent oversight function requires the presence on the board of a sufficient number of committed non-executive or supervisory directors, who, in addition to not performing management duties in the company, are also devoid of any particular bonds of interest (significant shareholder, employee, other) with them. This can be achieved in both systems (one-tier and two-tier boards), and the Recommendation therefore would not include any statement which would express a preference for any of these two formal structures.

But the Recommendation should contain a statement aiming at fostering the role of non-executive and supervisory directors, along the following lines: The administrative, managing and supervisory bodies should include an overall balance of executive/managing and non-executive/supervisory directors (and in particular independent non-executive or supervisory directors) such that no individual or small group of individuals can dominate the decision taking.

2.2.2. Composition of the whole (supervisory) board

In some Member States, corporate governance codes include provisions which seek to determine precisely how many independent non-executive or supervisory directors should be present in the (supervisory) board. It is advocated in one country, for example, that independent directors should account for half the members of the board in widely-held companies, and at least a third in other companies. Other examples of national provisions are: a) that there should be an ample majority of external directors on the board, and among them a very significant number of independent directors, or even b) that a maximum of one member of the supervisory board need not be independent.

In view of the different legal systems existing in Member States, it does not seem desirable to include in the Recommendation a precise statement as to the number of independent directors which should be present in the (supervisory) board as a whole. But the Recommendation would include a general statement in this respect, along the following lines: A number of independent directors should be elected to the (supervisory) board of companies that is adequate in relation to the total number of non-executive or supervisory directors and significant in terms of representativeness.

2.2.3. *Chairman - CEO*

The need for a separation of the roles of chairman and CEO is an issue which is widely debated in Europe with respect to the one-tier system. The two-tier system, which by nature is built on a formal separation of the two roles, actually raises similar concerns when the chairman of the supervisory board is the former CEO. In both systems, the combination of these roles may be seen as having both advantages (it facilitates the flow of information and communication between the management and the oversight functions) and disadvantages (a confusion of roles may not lead to optimal resolution of some conflicts of interest).

In the absence of a clear consensus, it is not considered desirable to include in the Recommendation a statement aimed at presenting the separation of these roles as best practice. In companies where the roles are combined, the necessary safeguards in dealing with conflicts of interest would be ensured through the provisions of the Recommendation on the definition of independent directors and the composition and role of the committees.

2.2.4. *Nomination, Remuneration and Audit Committees*

The role of non-executive or supervisory directors is commonly perceived as crucial in three areas, where the potential for conflict of interest of management is particularly high: a) nomination of directors to fill board vacancies, which raises issues linked to the selection of the non-executive or supervisory directors who are to oversee management or to the continuation in office of management, b) remuneration of directors, which entails in particular the determination of the criteria and amount of the variable part of the remuneration attributed to management, and c) audit, which covers both the way in which performance of management is accounted for and reported, and the way in which the internal control procedures are established and implemented.

Boards should be organised in such a way that a sufficient number of independent non-executive or supervisory directors play an effective role in these areas. It is therefore proposed that the Recommendation presents as best practice the creation of nomination, remuneration and audit committees within the (supervisory) board.

On 16 March 2004, the Commission adopted a proposal for a Directive modernising the 8th Company Law Directive on statutory audit. Under this proposal, “public interest entities” would be required to set up an audit committee composed exclusively of non-executive or supervisory directors. It is nevertheless considered fully appropriate for the Recommendation to deal

with the audit committee, for two fundamental reasons:

- a) time will elapse before the proposal of 16 March is finally agreed by Council and Parliament and subsequently transposed into national law, which means that listed companies will not be faced in the short term with a requirement to set up an audit committee. In the meantime, the Recommendation to be adopted in September 2004 would usefully encourage the creation of audit committees by listed companies;
- b) the provisions on audit committees included in the proposal of 16 March do not go beyond a few general principles, which would usefully be completed by the more detailed provisions to be included in the Recommendation on 1) the composition, role, operation and transparency of the audit committee and 2) the definition of - and criteria for - independence of directors.

For the sake of clarity, the Recommendation would consistently refer to the “nomination”, “remuneration” and “audit” committees, but it could be explicitly stated that other denominations can be given to committees performing equivalent functions. In addition, the Recommendation would not seek to limit in any way the freedom for boards to set up other committees charged with performing any other functions.

2.2.5. Role of the committees towards the (supervisory) board

In principle, the (supervisory) board has sole statutory decision-making authority and, as a collegial body, is collectively accountable for the performance of its duties. The (supervisory) board has the power to determine the number and structure of the committees which it deems to be appropriate to facilitate its own work, but these committees are in principle not to be a substitute for the (supervisory) board.

In such a context, it is proposed to state explicitly in the Recommendation that the 3 committees, which should be set up by the (supervisory) board, should make recommendations aimed at preparing the decisions to be taken by the (supervisory) board itself. The purpose of the committees is to increase the efficiency of the (supervisory) board’s work by making sure that decisions are based on due consideration, and to help organise its work with a view to ensuring that the decisions it takes are free from material conflicts of interest. The creation of the committees is not intended to remove the matters considered from the purview of the board itself.

However, boards should not be precluded from delegating part of their decision-making powers to committees when they consider it appropriate and when this is not against applicable law. The Recommendation would therefore make clear that the terms of reference of any committee created should be drawn up by the (supervisory) board, and that any delegation of decision-making power would have to be explicitly declared and properly described.

2.2.6. Flexibility in setting up the committees

Since the Recommendation would invite Member States to foster the creation by companies of the 3 committees, at a minimum on a “comply or explain”

basis, companies will remain free to decide any arrangements which they see appropriate in their particular circumstances.

In line with this flexibility, the Recommendation could nevertheless contain some further precisions along the following lines: a) what is recommended is essentially that companies make sure that the functions traditionally assigned to the 3 committees are performed, but they are free to create less than 3 committees and group the functions as they see fit; b) in companies where the (supervisory) board is small, the functions assigned to the 3 committees may be performed by the (supervisory) board as a whole, provided that it meets the requirements applicable to the composition advocated for the committees; c) creation of any of the committees may be replaced by the use of other structures which would be mandatory under national law and considered to be functionally equivalent.

2.3. Profile of (independent) non-executive or supervisory directors

In order for non-executive or supervisory directors to play an effective role, they should have proper competences and enough time (which is true also for executive or managing directors). In addition, a sufficient number of them should meet appropriate independence criteria.

Appointment of non-executive or supervisory directors should be based on adequate information being provided on these issues and should be refreshed with sufficient frequency. Non-executive or supervisory directors should therefore be appointed for specified terms subject to re-election – at intervals of no more than four years (at most) - and to the provisions relating to the removal of a director.

2.3.1. Qualifications

Most corporate governance codes insist on the need to have qualified individuals on the board, but at the same time recognise that the definition of what constitutes proper qualifications should be left to the company itself, because such qualifications will depend, inter alia, on its activities, size and environment and because they should be met by the board as a whole. There is nevertheless one issue which usually raises particular concern, i.e. the need for specific competence in the audit committee where some sophisticated knowledge is deemed to be indispensable.

In such a context, it is proposed to include in the Recommendation a general statement about the need for a balanced set of qualifications to be present on the (supervisory) board, along the following lines. The (supervisory) board should draw up a desired profile of itself and evaluate it periodically. The (supervisory) board should ensure that it is composed of members who, as a whole, have the required diversity of knowledge, judgement and experience to properly complete their tasks.

With respect to the members of the audit committee, it is proposed to include a statement clarifying that a) at least one audit committee member must have recent and relevant experience which results in the individual's sophistication in finance and accounting, and b) all other members of the audit committee

should be able to read and understand financial statements at the time of their appointment.

All new directors should follow a formal and tailored induction programme on joining the (supervisory) board, which covers the company's organisation and activities and his responsibilities as a director. The (supervisory) board should conduct an annual review to identify areas where directors need to update their skills and knowledge.

These statements would be supported with provisions aimed at ensuring a proper flow of information to the markets. When the appointment of a director is proposed, disclosure should be made of his particular competencies and the reasons why he is qualified to serve on the (supervisory) board. Every year, the (supervisory) board should include in its annual report a profile of the board's composition and an explanation as to why individual directors are qualified to serve on the board in the light of this profile.

2.3.2. *Commitment*

Most corporate governance codes seek to make sure that directors will devote sufficient time to their duties. Several codes contain provisions applicable to non-executive or supervisory directors, and some contain provisions applicable to executive or managing directors. These provisions impose limitations on the number of directorships that may be held in other companies: positions of chairman or of executive or managing director are usually recognised as more demanding than positions of non-executive or supervisory director, but the precise numbers of other directorships acceptable vary widely. In addition, these provisions usually take into account only directorships in other listed companies not belonging to the company's group.

It is highly doubtful that any purely mathematical approach would make sense in a Recommendation at EU level. Indeed, the involvement required from a director may vary widely depending on the company and its environment. Furthermore, we see no clear reason why the positions in other companies which are not listed or which belong to the company's group should be simply ignored. Finally, the issue of whether directors have enough time to devote to their duties does not seem specific to non-executive or supervisory directors.

On these grounds, it is proposed to include in the Recommendation a general statement about the need for availability of all directors: each director should apply to his duties the necessary time and attention, and should undertake to limit the number of any directorships held in other companies to such an extent that the proper performance of his duties is assured.

Such a statement would be supported with provisions aimed at ensuring a proper flow of information. When the appointment of a director is proposed, his other significant commitments should be disclosed, with a broad indication of the time involved. The board should be informed of subsequent changes. Every year, the board should collect data on such commitments, and make the information available in its annual report.

2.3.3. *Independence*

Generally, corporate governance codes adopted in Member States agree on the need for a significant proportion of non-executive or supervisory directors to be independent, i.e. free from any material conflict of interest. Independence is most often understood as the absence of close ties with management, controlling shareholders and the company itself. Although the concept of independence is similar in many codes, precise definitions of independence vary: the types of relationship judged to impede directors' independence are listed with more or less specificity.

In the absence of a universal understanding of what independence precisely entails, it is proposed that the Recommendation include a general statement aimed at describing what the general objective is. That general statement would then be accompanied by a list of minimum criteria, which Member States could make more precise as required.

The general statement could be drafted as follows: "A director is considered to be independent when he is free from any business, family or other relationship - with the company, its controlling shareholder or the management of either – that creates a conflict of interest such as to jeopardise exercise of his free judgement."

The minimum criteria to be included in the list would be as follows:

- Not to be an executive or managing director of the company or an associated company, and not having been in such a position for the previous five years;
- Not to be an employee of the company or an associated company, and not having been in such a position for the previous five years;
- Not to receive, or have received, additional remuneration from the company or an associated company apart from a fee received as non-executive or supervisory director (such additional remuneration covers in particular any participation in a share option or any other performance-related pay scheme);
- Not to be or to represent in any way the controlling shareholder(s) (control being determined with due account of the shares held by natural persons or legal entities which cooperate under an express or tacit, oral or written, agreement);
- Not to have, or have had within the last year, a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, director or senior employee of a body having such a relationship. Business relationships include the situation of a significant supplier of goods or services (including financial, legal, advisory or consulting services), of a significant customer, and of organisations that receive significant contributions from the company or its group;

- Not to have been partner or employee of the external auditor of the company or an associated company within the last three years;
- Not to be executive or managing director in another company in which an executive or managing director of the company is non-executive or supervisory director, and not to have other significant links with executive directors of the company through involvement in other companies or bodies;
- Not to have served on the board for more than 12 years (at most);
- Not to be a close family member of an executive or managing director, or of persons in the situations referred to above;

It is worth observing that directors' shareholdings of a size that does not give control of the company do not violate the independence requirement; they are even generally perceived as positive, since they align directors' interests with those of the entire shareholding body.

The ultimate determination of what constitutes appropriate board composition and just what constitutes independence is fundamentally an issue for the (supervisory) board itself to determine. The (supervisory) board may indeed consider that, although a particular director meets all of the above criteria, he cannot be held to be independent owing to the specific circumstances of the person or the company, and the converse also applies.

In this context, the Recommendation would confirm this ultimate responsibility of the (supervisory) board, and make clear that such flexibility should be accompanied by the provision of proper information. When the appointment of an independent director is proposed, the company should disclose whether it considers him to be independent, and on what grounds. Since the criteria should be met throughout the entire tenure, companies should also disclose annually which directors they consider to be independent, and on what grounds. To ensure the accuracy of the information provided on the independence of directors, it could be stated that the company should require the independent directors to revalidate their independence periodically.

Finally, since independence is not simply a matter of absence of certain relationships, but also a matter of approach in fulfilling one's responsibilities, it is proposed to include in the Recommendation a general statement about the duties of independent directors, which would clarify that the independent director undertakes a) to maintain in all circumstances his independence of analysis, decision and action, b) not to seek or accept any unreasonable advantages that could be considered as compromising his independence, and c) to clearly express his opposition in the event that he finds that a decision of the (supervisory) board may harm the company.

2.4. The board committees: common features

The Recommendation would contain minimum standards on each of the 3 committees, related to its composition, role, operation and transparency.

Certain features can nevertheless be considered to be applicable to all 3 committees, and would then be presented in a general section.

2.4.1. Size of the committees

When committees are created, they would normally be composed of three members at least. In companies with small (supervisory) boards, they could exceptionally be composed of two members only.

2.4.2. Composition of the committees

Chairmanship and membership of the committees should be decided with due regard to the need to ensure that committee membership is refreshed and that undue reliance is not placed on particular individuals.

2.4.3. Terms of reference

The exact mandate of each committee created must be described in the terms of reference drawn up by the (supervisory) board. Such terms of reference must be made available to the public at least once a year (as part of the information to be disclosed by the company in its annual report on its corporate governance structures and practices).

2.4.4. Available resources

Companies should ensure that committees are provided with sufficient resources to discharge their duties, which includes the right to obtain – in particular from officers of the company – all the necessary information or to seek independent professional advice on issues falling in their area of competence.

2.4.5. Attendance at committee meetings

With a view to ensuring the autonomy and objectivity of the committees, only the committee members are entitled to attend its meetings. Others may attend meetings at the invitation of the committee, which may require certain officers or experts to attend.

2.4.6. Transparency

Committees discharge their duties within the set terms of reference, and ensure that they regularly report to the board about their activities and results.

The chairman of each committee should be available to answer shareholders' questions at the general meeting.

2.5. The Nomination Committee

2.5.1. Composition

The Action Plan suggested that the nomination committee should be composed mainly of executive directors, since they can usefully bring their deep knowledge of the company and its human resources. In the consultation organised on the Action Plan, a large majority of respondents suggested that

ensuring proper input from executives did not require the nomination committee to be composed in the majority of executives, and expressed their strong preference for a group composed mainly of independent non executive directors. In this context, it is proposed to include in the Recommendation the following provision:

- the nomination committee should be composed of a majority of independent non-executive or supervisory directors.

This composition leaves room for the presence of non-executive or supervisory directors who would not meet the independence criteria, so as to allow for the presence of, for example, representatives of the controlling shareholders (if deemed appropriate). Furthermore, it also leaves room for the presence of executive directors, where this is possible under national company law and as long as they do not form the majority of the nomination committee.

In this line of thinking, and with a view to making sure that the CEO will be properly involved in the discussions held by the nomination committee, the Recommendation would explicitly state that a) the CEO must be among the members of the nomination committee, in companies with a unitary board, and b) in companies with a dual board, where the chairman of the managing board cannot be a member of committees created within the supervisory board, he must be adequately consulted by the nomination committee.

2.5.2. *Role*

In most Member States, the general meeting of shareholders is responsible for appointing and removing directors on the basis of proposals tabled by the board. In the two-tier system, this is true only for supervisory directors, since the managing directors are appointed and removed by the supervisory board. Specificities exist in some Member States, for example with self-selecting supervisory boards or workers' codetermination.

Generally speaking, the role of the nomination committee should essentially be to make sure that the appointment and removal process is organised in as objective and professional a way as possible. The nomination committee should therefore make recommendations to the (supervisory) board with respect to the appointment and removal of directors by the body competent under national company law.

In this context, the nomination committee should at least:

- Identify and nominate, for the approval of the (supervisory) board, candidates to fill board vacancies as and when they arise. In doing so, the nomination committee should evaluate the balance of skills, knowledge and experience on the board, prepare a description of the roles and capabilities required for a particular appointment, and assess the time commitment expected;
- Periodically assess the structure, size and composition of the one-tier or two-tier board, and make recommendations to the (supervisory) board with regard to any changes;

- Periodically assess the skills, knowledge and experience of individual directors, and reporting on this to the (supervisory) board;
- Properly consider issues related to succession planning.

In addition, the nomination committee should review the policy of the (management) board for selection and appointment of senior management.

2.5.3. *Operation*

The nomination committee should consider proposals made by relevant parties, including management and shareholders.

In performing its duties, the nomination committee should be able to use any resources it deems appropriate, including external advice or open advertising.

2.5.4. *Transparency*

The nomination committee should make available its terms of reference, explaining its role and the authority delegated to it by the (supervisory) board. The committee should also make a statement in the annual report about its membership, the number of its meetings and attendance over the year, and its main activities.

2.6. **The Remuneration Committee**

2.6.1. *Composition*

The remuneration committee should be composed exclusively of non-executive or supervisory directors, who are in the majority independent.

2.6.2. *Role*

In the area of remuneration, corporate governance codes adopted in Member States tend to focus primarily on the remuneration of executive or managing directors, since the potential for conflicts of interest and abuses is essentially located there. Codes vary with respect to the nature of the intervention of the remuneration committee: it is most often supposed to make recommendations to the (supervisory) board, whereas sometimes it is presented as a decision-making body. Many codes also recognise that some consideration should be given at board level to the remuneration policy for senior management. Finally, the issue of stock options is sometimes granted special attention.

Based on these observations, it is proposed to include in the Recommendation a series of statements along the following lines (knowing that Member States are free, as for any other part of the Recommendation, to adopt more stringent rules).

With respect to executive or managing directors, the committee should at least:

- Make proposals to the (supervisory) board on the remuneration policy for executive or managing directors. Such policy should address all forms of compensation, including in particular the fixed remuneration, performance-

related pay-schemes, pension arrangements, and termination payments. Proposals related to performance-related pay schemes should be accompanied with recommendations on the related objectives and evaluation criteria, with a view to properly aligning the pay of executive or managing directors with the long-term interests of the shareholders;

- Make proposals to the (supervisory) board on the individual remuneration to be attributed to executive or managing directors, ensuring that they are consistent with the remuneration policy adopted by the company and the evaluation of the performance of the directors concerned. In doing so, the committee should be properly informed on the total compensation obtained by the directors from other companies affiliated to the group;
- Make proposals to the (supervisory) board on a standard form of contract for executive or managing directors;
- Oversee the process whereby the company complies with any existing provisions regarding disclosure of remuneration.

With respect to senior management (as defined by the (supervisory) board), the committee should at least:

- Make recommendations to the executive or managing directors on the level and structure of remuneration for senior management;
- Monitor the level and structure of remuneration for senior management, on the basis of adequate information provided by executive or managing directors.

With respect to stock options, which may be granted to directors, managers, or other employees, the committee should at least:

- Debate the general policy regarding the granting of options and make any related proposals to the (supervisory) board;
- Review the information provided on this topic in the annual report and to the shareholders meeting where relevant;
- Make proposals to the (supervisory) board concerning the choice between granting subscription or purchase options, specifying the reasons for its choice as well as the consequences that this choice has.

2.6.3. Operation

The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive or managing directors.

The remuneration committee may avail itself of consultants, who may be useful in providing the necessary information on market standards for remuneration systems. The committee should be responsible for establishing the selection criteria, selecting, appointing and setting the terms of reference for any remuneration consultants who advise the committee.

2.6.4. *Transparency*

The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the (supervisory) board. The committee should also make a statement in the annual report about its membership, the number of its meetings and attendance over the year, and its main activities.

2.7. The Audit Committee

2.7.1. *Composition*

The audit committee should be composed exclusively of non-executive or supervisory directors, who are in the majority independent.

2.7.2. *Role*

Ensuring that the financial reports and other related information disseminated by the company present an accurate and complete picture of the company's position and monitoring the procedures established for the evaluation and management of risks are usually seen as two key responsibilities of the (supervisory) board. In this context, most corporate governance codes assign to the audit committee an essential role in assisting the (supervisory) board to fulfil these duties. It is therefore proposed to include in the Recommendation the following statements on the main tasks to be performed by the audit committee.

With respect to the internal policies and procedures adopted by the company, the audit committee should at least:

- Monitor the integrity of the financial information provided by the company, in particular by reviewing the relevance and consistency of the accounting methods used by the company and its group (including the criteria for the consolidation of companies);
- Review the internal control and risk management systems, with a view to ensuring that the main risks (including those related to compliance with exiting legislation and regulations) are properly identified, managed and disclosed;
- Ensure the effectiveness of the internal audit function, in particular by making recommendations on the selection, appointment, reappointment and removal of the head of the internal audit department and on the department's budget, and by monitoring the responsiveness of management to its findings and recommendations.

With respect to the external auditor engaged by the company, the audit committee should at least:

- Make recommendations in relation to the selection, appointment, reappointment and removal of the external auditor, and to the terms and conditions of his engagement;

- Monitor the external auditor’s independence and objectivity, in particular by reviewing the audit firm’s compliance with applicable guidance relating to the rotation of audit partners, the proportional level of fees paid by the company, and other related regulatory requirements;
- Keep the nature and extent of non-audit services under review, based inter alia on disclosure by the external auditor of all fees paid by the company and its group to the audit firm and network, with a view to preventing material conflicts of interest from arising. The committee should set and apply a formal policy specifying the types of non audit services a) excluded, b) permissible after review by the committee, and c) permissible without referral to the committee;
- Review the effectiveness of the external audit process, and the responsiveness of management to the recommendations made in the external auditor’s management letter;
- Investigate the issues giving rise to any resignation of the external auditor, and making recommendations as to any required action.

2.7.3. *Operation*

The company should provide an induction programme for new audit committee members, and subsequent relevant training on an ongoing and timely basis. All committee members should be provided in particular with full information relating to the company’s specific accounting, financial and operational features.

The management should inform the audit committee of the methods used to account for significant and unusual transactions where the accounting treatment is open to different approaches. In this respect, particular attention should be paid to both the existence of, and the justification for, any activity carried out by the company in offshore centres and/or through special purpose vehicles.

The audit committee shall decide whether and, if so, when the chief executive officer or chairman of the managing board, the chief financial officer (or senior employees responsible for finance, accounting, and treasury matters), the internal auditor and the external auditor, should attend its meetings. The committee should be entitled to meet with any relevant person outside the presence of executive or managing directors, if it so wishes.

The audit committee shall act as the principal contact point for the internal and external auditors.

The audit committee should be informed of the internal auditor’s work programme, and receive internal audit reports or a periodic summary.

The audit committee should be informed of the external auditor’s work programme, and should obtain a report by the external auditor describing all relationships between the independent auditor and the company and its group. The committee should obtain timely information about any issues arising from the audit.

The audit committee should be free to obtain advice and assistance from outside legal, accounting or other advisors as it deems necessary to carry out its duties, and should receive appropriate funding from the company to this effect.

The audit committee should ensure that employees have the possibility of reporting alleged irregularities in the company, by way of complaints or through anonymous submissions, to the chairman of the (supervisory) board, and that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

The audit committee should report to the (supervisory) board on its activities at least once every six months, at the time the yearly and half-yearly statements are approved.

2.7.4. Transparency

The audit committee should make available its terms of reference, explaining its role and the authority delegated to it by the (supervisory) board. The committee should also make a statement in the annual report about its membership, the number of its meetings and attendance over the year, and its main activities.

Where there is disagreement between the audit committee and the (supervisory) board, and such disagreement cannot be resolved after adequate discussion, the audit committee should have the right to report the issue to the shareholders as part of the report on its activities.