



EUROPEAN COMMISSION

Internal Market and Services DG

FREE MOVEMENT OF CAPITAL, COMPANY LAW AND CORPORATE GOVERNANCE
Company law, corporate governance and financial crime

Brussels, 2 June 2009
MARKT/F2/CU D(2009)

EUROPEAN CORPORATE GOVERNANCE FORUM

Minutes of the meeting of 19 May 2009

1. APPROVAL OF THE AGENDA

The agenda was adopted unanimously.

2. EXECUTIVE REMUNERATION

The Chairman thanked the members of the Forum for their contributions to the Forum statement on executive remuneration.

One member asked whether other opinions than that of the Forum had been taken into account in the process of preparing the recommendations. The Chairman stressed that many stakeholders had been consulted through the stakeholder meeting on 23rd March and a number of parallel bilateral meetings. Furthermore, a thorough discussion on the recommendations had taken place inside the Commission. On the substance, the Commission explained that the Recommendation on Directors' remuneration complements the 2004 recommendation on directors' remuneration, but still leaves some questions open, such as the possible standardisation of disclosure on remuneration. The Forum's recommendation in this respect could therefore still be taken up, e.g. in the context of the forthcoming revision of the Transparency Directive¹. Still another question would be how to achieve that the information provided by the issuers is comparable. The Recommendation on remuneration in the financial services sector leaves flexibility to companies and to supervisors how to apply the principles included in the recommendation in their financial institutions and as to the methods of supervision. This recommendation mainly links remuneration to risk taking and envisages that companies include remuneration policy in the risk management process. The Commission furthermore pointed out that the Recommendation on remuneration in the financial services sector has been prepared following the work of CEBS on remuneration guidelines and that the Commission could work with CEBS in consulting on this issue.

¹ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L390, 31.12.2004, p. 38

The Commission attended a CEBS public consultation meeting in London, where information was shared with stakeholders from the banking sector and other financial sectors and which served as a forum for discussion. The Commission has also adopted a Communication, accompanying the two recommendations, which explains how the recommendations are connected, the reasons for their adoption and future steps. Since the adoption of the Communication and the recommendations, a consultation on the possible amendment of the Capital requirements directive has taken place. This amendment is scheduled for adoption on 17 June 2009. In the Communication, it is also mentioned that the Commission will look into the other financial sectors than the banking sectors, to investigate whether additional measures are appropriate in that field.

One member expressed his view that a consultation period of one week for the CRD consultation was too short. Another member noted that the politicization of legislative processes does not benefit the quality of the proposal, as can be seen for instance with a view to the recent proposal for a directive on alternative investment fund managers. The Chairman remarked that it should be taken into account that processes tend to speed up at the end of a Commission, and that a normalisation of processes is expected with the installation of a new Commission.

One member raised the question why risk management is only specifically mentioned in the recommendation on financial institutions although it is relevant also in other sectors. The Commission confirmed this view but emphasized the particular importance in the financial services sector. Two other members shared this view. Risks would be higher and more difficult to assess in the financial services sector, and risk taking in the financial sector goes down to the lowest hierarchical levels. Another member added that in some Member States there may be companies from other sectors that are of systemic interest.

The Chairman recalled that the Forum would be able to continue its discussion on this topic, as the recommendations will be evaluated.

About the evaluation of the recommendations, which is planned for 2010, one member suggested that interested members of the Forum, and in particular those coming from the financial sector, could be involved. It would be interesting to see whether the recommendation have led to a change in remuneration practices. Another member expressed the view that remuneration practices will change. A third member added that the recommendations could also be used by national corporate governance committees as a frame of reference for their work. The downside of it would be that the recommendations could be seen as an encouragement to return to two years of severance pay in those Member States where the current rule on severance pay prescribes a maximum of less than two years. Another member took the view that it could be the case that some Member States might face a bigger problem with reward for failure but that this drawback had to be viewed in the light of the overall improvement.

Two members expressed concerns about regulatory arbitrage. If traders were not well enough paid in the EU any more they would move to places where the rules do not apply. In the hedge funds area, there would already be a tendency to move to Switzerland. Another member expressed some scepticism as to the effect of the recommendations. As soon as the current attention to the issue declines things would be likely to go back as to where they were. However, one should hope that there will be a lasting change as to the approach to risk management, and also as to the compensation of risk management officers, who should control traders. Authority and compensation of risk management

officers should increase. On the possibility of regulatory arbitrage, the Commission recalled that the G20 have endorsed the FSF principles on remuneration, which will stimulate a level playing field. Also the US seems to be thinking about additional measures on remuneration. The view was expressed that the EU should work with the G20 to ensure global standards to prevent regulatory arbitrage.

Two members noted that the result of limits on variable pay is that fixed remuneration is increasing. One of them stated that, although deferment of remuneration is very useful, there should also be short term reward for genuine short term value creation. There is a risk that companies become more vulnerable to the cycle. It further showed concern over how the recommendations will be implemented by supervisors. If financial institutions enforce the recommendation too strictly they would lose their competitiveness. At the same time, a less rigid application could lead the regulators to becoming too prescriptive. It would seem important that they take a principle based approach. Another member admitted that it is difficult to predict how this will work in practice, but took the view that that the recommendation is not too prescriptive.

As regards remuneration policy as a risk factor, one of the members took the position that inappropriate remuneration policies should not lead to higher capital requirements. Regulators should ensure appropriate implementation of the principles with the tools that are already at their disposal, such as setting up a dialogue, giving instructions to the institution or, as a last resort, declaring the board not fit and proper or even withdrawing the banking license. In practice, writing a strongly worded letter to the board would often suffice. Capital requirements however should be based on actual risk. Another member reminded that if the remuneration culture is too risk prone the institution could fall within a different risk category, which would justify extra capital requirements. A third member considered that it will be difficult to translate a certain remuneration policy in a risk category. The Chairman added that the possibility of additional capital requirements would give institutions the choice between complying with remuneration principles and possible administrative measures to that end and having more capital. One of the members took the view that it could be dangerous if institutions could continue to have inappropriate, risky remuneration policies by simply increasing their capital. Another member reminded that additional capital requirements would increase the need of the institutions for direct financing. The invention of instruments aimed at avoiding the need to put in such capital would however been one of the reasons for the current crisis.

It was suggested that the planned review of the recommendation should be an open minded review, taking into account the consequences and results and allowing to reopen the discussion. The Commission confirmed that the idea is a broad review, not only an implementation report. The follow-up to the invitation to Member States, contained in the Recommendation on directors' remuneration, to organise national consultations on its implementation will be discussed with Member States, possibly already in June, if not, in September. Suggestions from the Forum are welcome. The Commission would also be interested to hear the views of Forum members on the issue of standardisation of disclosure on remuneration. One member indicated that CESR is already undertaking work in the area of standardisation.

Another member asked whether the Commission plans to undertake further work on the issue of performance criteria. The Commission recalled that the recommendations already contain some guidelines in that respect, for instance that they should include non-financial criteria. To go more into the detail at EU level would seem difficult if the objective is to avoid being too prescriptive. Details have therefore been left to Member

States. Another member suggested that the developments in other jurisdictions and at the level of the G20 should be monitored. The Chairman explained that the Commission is a member of the G20 committee in charge and announced that it will report on the developments at the Forum's next meeting in November.

3. CORPORATE GOVERNANCE OF BANKS

The Commission introduced the item by referring to the 4 March Commission communication where a review on CG in financial institutions has been announced for the end of 2009. The paper distributed ahead of the meeting would set out the suggested methodology for that report. DG MARKT currently is examining EU and international legislation on corporate governance of financial institutions. The preliminary conclusion is that these texts are of a very general nature. Further, case studies of approximately ten financial institutions will be carried out. The proposed selection includes some good and some less good examples and also includes some US firms. One criterion that has been applied for this pre-selection is the accessibility of information on the institution.

Work is at an early stage. After the final selection of the cases, a database study of, among others, annual accounts will be done, and the Commission will organise interviews representative of the firms that have been selected.

Furthermore, the idea is to set up a small group of experts in this field that can help the Commission with research and conclusions over the summer. Forum members who would be interested in participating in this work were invited to join this group.

One member raised the question whether other institutions would carry out a similar exercise. The Commission indicated that the European Corporate Governance Institute (ECGI) is looking into the same issue and that the UK, with reports from David Walker and from the treasury, is working into the same direction. Another member mentioned that the Transatlantic Corporate Governance Dialogue, which will be held in September in Washington, will also address the issue of Corporate Governance in financial institutions.

One of the members stressed that the main issue in this context would concern business models, and wondered whether boards could be expected to discuss these issues. Another member said that the key issue with regard to boards is expertise. It explained that usually clients of banks are invited to the board for their connections. However, expertise might get in conflict with independence. It would therefore be essential to find the right balance. Another member agreed that expertise is important, but there can also be too much expertise, which could prevent the non-executives from challenging the board. Board evaluation is very important. One of the other members however stressed that there had been cases in the current crisis where the evaluator had failed to notice the issues that had already been coming up between board members. In general, it would seem difficult to get a real scent on how CG works in practice if a formalistic approach is taken.

One of the other members took a different approach. Even in cases where only the executives had expertise in finance and strategy was never discussed at board level banks had been able to manage in the crisis if a good risk management system was in place. It is difficult to find enough people with expertise, but not necessary if processes are taken seriously, and if the internal control, the audit committee and the risk managers have sufficient authority. Non-executive directors should rely on good systems and on the

expertise of risk managers. Two other members agreed that the culture is important. One of these members also considered that it is important to have a key individual – the chairman – who is important for the functioning of the internal systems. Another member stressed that clear terms of reference are needed for board evaluations.

Another member remarked that it is important for boards to know the corporate structure of the company. It noted that boards did not know what the real problems were. It further said that officers that are not members of the board take responsibility, because the board members rely on them because of their expertise. Another member expressed the view that the future banking systems will be different as not the boards but the executive committees will be in command in future.

Another member added that it had recently conducted research on corporate governance in Bulgarian banks. Banks might have high standards at group level, but that in the subsidiaries the systems are not in line with good corporate governance and largely limited to compliance with the (hard) law. That proves that it is important to speak also with the lower layers of such groups. It announced further comments on internal control and other issues to follow by e-mail. Finally, it noted that there is limited academic research material available on corporate governance in banks.

One of the other members said that the quality of risk analysis in financial institutions should be checked, in particular in relation to unpredictable risks. Were there risk elements that the financial institutions were not prepared for and that could have created systemic risk? Also, stress testing of the system is important.

The Chairman concluded it will indeed be difficult to identify exactly the reasons why one institution has been doing well in the crisis while another one has not. The Commission will mainly be in a listening mode, and also talk to supervisors. Two of the members suggested that the Commission could also talk with consultants and analysts.

One member asked what the role of the Forum should be in relation to this report. The Chairman stressed that this discussion had been helpful and that the Commission would hope that some members of the Forum would like to participate in the working group. Furthermore, the issue will be discussed further with the Forum in the next meeting in November. Another member stressed the importance of involving the Forum before any conclusions would be drawn from this work. Given that the Commission would work on the basis of a relatively small sample decision there would be a need to be cautious.

4. EMPTY VOTING AND TRANSPARENCY OF INVESTORS' POSITIONS

One of the members explained that, following the discussion of the issue at the last meeting, the future Forum statement should focus on three aspects: 1) that empty voting is dangerous and that there is a need to deal with the issue; 2) that any measure at this stage however should be limited to disclosure (and that no more far reaching measures, as e.g. a prohibition to vote, should be envisaged at this stage); 3) the question to whom disclosure should be addressed. It should, however, be emphasized that incorrect (including lacking) disclosure would have to be considered as a false statement to the market under the Market Abuse Directive. Although a full prohibition to vote without corresponding economic interest would seem preferable in theory, it would risk leading to each decision of a GM being challenged.

Another member supported the proposed approach as a first step. A third member expressed doubts about the proposed prohibition to vote own shares that have been lent by the company to a third party. Another member, however, took the view that such a measure was indispensable in order to avoid a circumvention of the prohibition – under the Second Company Law Directive – to vote own shares. Another member pleaded for going further. Empty voting is a serious problem whose significance is growing dramatically. The prohibition should not be contained in a recommendation but laid down in legislation. The Hedge Funds Standards Board has made a clear statement and hedge funds have undertaken not to engage in empty voting. One of the other members suggested adding to the Forum statement the request to contemplate what further measures could be taken. Another member recalled that one possible sanction under market abuse rules would be to invalidate a vote retroactively. Furthermore, it should be clarified in the statement that although the introduction of the record date system by the Shareholder Rights Directive might have drawn attention to the problem it is not the cause of it. The text of the paper should be specific in its recommendations: borrowed stock should not be voted, and lent shares should be recalled. Furthermore, it should be clarified that hidden ownership (cash-settled derivatives etc) would be as damaging to the market as empty voting. Two other members recalled that the Forum, at its February meeting, had considered the statement a first step that would not exclude going further at a later stage. The paper should therefore clarify that there is a need for a two-step process. Another member stressed that the stricter the sanction, the more important it would be to have clear definitions in place. It questioned whether the term "borrowed shares" would be clearly defined. One of the other members took the view that the fact that a small share of cases might not be clear-cut should prevent no one from having a clear policy. Another member, however, reminded that in many cases of "empty voting" shareholders would have a certain economic interest in the company but boost their voting power by borrowing additional stock.

The Chairman concluded that there was agreement on the ideas contained in the draft paper, although views differed somewhat on whether the Forum should go any further at this stage. The statement will be finalised in written procedure.

5. CROSS-BORDER VOTING

One member took the view that it is not very clear from the public consultation that was launched in April on the harmonisation of securities laws² whether shareholder voting is covered - in some contexts voting is mentioned, in others it is not. Should the directive leave the issue out we would risk losing another five years in improving the current situation. In its view, the cooperation between the three groups (ECGF, Cesame and Legal Certainty Group) should start quickly and lead to concrete proposals for provisions to be integrated into the proposal for a directive. The mandate should focus strictly on technical issues. As far as the question of costs is concerned, that member pointed out that the shareholder will pay either way: either through the bank fees or through reduced dividends (in the case the costs are born by the issuer). The decision should therefore rather be taken on the basis considering who would be in a better position to negotiate with the banks: this would clearly be the issuer and not the (retail) investor.

² See DG MARKT's website at http://ec.europa.eu/internal_market/consultations/2009/securities_law_en.htm

Another member expressed its lack of understanding of how the current structure has developed. In order to be efficient, the process should be organised and paid for by the issuers. In order to be able to do this, issuers would however have to be given the means to identify their shareholders. The minimum would be that the chain confirms the entitlement of a shareholder.

It was concluded that the Forum supports these ideas of its two members and that there is an urgent need for action. The Commission announced that another meeting between representatives of the three groups will be organised before the summer break.

6. PROTECTION OF MINORITY SHAREHOLDER RIGHTS – STATE OF PLAY

One member introduced its ideas on future lines of development of the work of the Forum in the area of minority rights. It noted that the issue is very complex, as it is governed by different laws in the Member States. It further presented the three issues it had identified as being the most problematic ones: 1. Transactions for corporate control, which are partly covered by the Takeover bids Directive³; 2. Squeeze-out provisions, which, according to the Winter Group, should be included in the Second Company Law Directive; and 3. Related party transactions, which is the most sensitive issue.

Another member said that it would like to add a fourth problem to that list, namely the fact that the corporate governance infrastructure of corporate governance codes and "comply or explain"-systems does not work very well in situations where there is a controlling shareholder, certainly because the Forum has been a strong advocate of comply or explain. The outside study on the functioning of comply-or-explain that has been commissioned by the Commission might shed some light on this point but further research would seem necessary in that field. Possibly, this could lead to the conclusion that comply or explain does not work in that situation, unless the mechanism is supported by law.

Another member considered that a statement from the Forum would be likely to have a bigger impact if it focused on related party transactions, clarifying that a disenfranchisement of the controlling shareholder would seem justified in order to provide an incentive for buying out minorities. One member however, reminded that this question is much contested outside the UK. Two other members supported the approach to focus on related-party transactions at this stage as this would be the core issue in continental Europe. Issues like acting in concert should be dealt with in another context, notably the review of the Takeover bids Directive. A Forum statement on related party transactions could mark an important step forward. One of these members stressed that, in this context, it should be stated that the audit committees – as other committees – should be controlled by independent directors and should be competent for the approval of any material related party transaction.

A third member stressed the importance of looking at minority shareholder protection. It should first of all be clarified that this protection does not only relate to small shareholders. Furthermore, it should be kept in mind that such minority rights can also be used to blackmail the controlling shareholder. This risk would justify the existence of

³ Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids; OJ L 142, 30.4.2004, p. 12

squeeze-out rules. The Forum should look at related party transactions, the functioning of comply-or-explain and the role of independent directors. A difficult issue would be the question what the consequence should be where minority shareholders and the controlling shareholder do not agree, and whether such cases would have to be submitted to a court. This member expressed some hesitations about giving too many powers to independent directors. This would in the end be a question of accountability and of the selection process. Another member proposed to involve independent advisors.

One of the other members proposed a two-step approach: because of a need to set priorities the Forum, in a first step, it should focus on related-party transactions but widen the research in a second step.

7. UPDATES ON ONGOING COMMISSION INITIATIVES

7.1. Study on monitoring and enforcement of Corporate Governance codes in the Member States

The Forum was informed about the meeting with the contractor on the interim report that took place on 1 April. The draft final report is due for 23 July. Another meeting with the contractor will then be scheduled early in September.

7.2. Simplification of the Company law Acquis

The proposal to modify the First and the Eleventh Company law Directives is still blocked by the question of newspaper publications. On the proposal on mergers and divisions of September 2008, a compromise was reached between European Parliament, Council and Commission on 22 April 2009. The file is now with the lawyer linguists for finalisation.

7.3. Proposal for a Statute of a European Private Company (SPE)

A number of issues still need to be resolved, including in particular the question of workers' codetermination.

8. ANNUAL REPORT 2008

The draft established by the secretariat will be circulated for adoption in written procedure.

9. AOB/CONCLUSION

The next meeting will take place on 4 November 2009.