



A Guide to Corporate Governance Practices in the European Union

ecoDa

CONFÉDÉRATION EUROPÉENNE DES ASSOCIATIONS D'ADMINISTRATEURS
EUROPEAN CONFEDERATION OF DIRECTORS' ASSOCIATIONS



A Guide to
Corporate Governance Practices
in the European Union



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International Finance Corporation
2121 Pennsylvania Avenue, NW,
Washington, DC 20433

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Contents

- Forewordvii
- Preface ix
- Acknowledgments x
- Executive Summary..... xi
- 1. European Context..... 1
 - 1.1. Why Is Europe Distinctive? 1
 - 1.2. Legislation, “Soft Law,” and Comply or Explain 5
 - 1.3. Summary 7
 - 1.4. Resources for This Chapter 7
- 2. Benefits of Good Corporate Governance 9
 - 2.1. Principles of Good Governance in European Companies 9
 - 2.2. Benefits Associated with Good Corporate Governance 10
 - 2.3. Challenges Related to Corporate Governance 11
 - 2.4. Tips 16
 - 2.5. Summary 16
 - 2.6. Resources for This Chapter 16
- 3. The Company 18
 - 3.1. The Three Sectors 18
 - 3.2. Governance and Organizational Variety within the Private Sector 18
 - 3.3. Governance and Organizational Variety within the Public Sector 20
 - 3.4. Governance and Organizational Variety in the Not-For-Profit Sector 21
 - 3.5. Transparency and Disclosure 22
 - 3.6. Challenges Associated with Corporate Reporting 23
 - 3.7. Tips 24
 - 3.8. Summary 24
 - 3.9. Resources for This Chapter 24
- 4. The Owners 26
 - 4.1. Stock Exchanges in Europe 26
 - 4.2. Shareholder Rights and Powers in Europe 27
 - 4.3. The European Model of Share Ownership 27
 - 4.4. The Structure of Company Ownership in Europe 30
 - 4.5. Shareholder Engagement 30
 - 4.6. Say on Pay 32
 - 4.7. Control-Enhancing Mechanisms 33
 - 4.8. Shareholder Engagement with the Board 34
 - 4.9. Tips 35
 - 4.10. Summary 35
 - 4.11. Resources for This Chapter 35

5. The Board.....	37
5.1. Diversity of Board Structures in Europe.....	37
5.2. Board Size and Composition.....	38
5.3. Directors' Duties.....	49
5.4. Directors and Conflicts of Interest.....	51
5.5. Committees.....	55
5.6. Board Evaluation.....	56
5.7. Nomination Process.....	57
5.8. Director Induction Process.....	57
5.9. The Board and Shareholder Engagement.....	57
5.10. Director and Board Development.....	58
5.11. Tips.....	59
5.12. Summary.....	59
5.13. Resources for This Chapter.....	60
6. The Management.....	62
6.1. The Dominant CEO.....	62
6.2. Remuneration.....	62
6.3. Succession.....	63
6.4. Performance and Internal Efficiency.....	63
6.5. Strategy.....	64
6.6. Risk Management and Internal Controls.....	64
6.7. External Auditors.....	65
6.8. Tips.....	66
6.9. Summary.....	67
6.10. Resources for This Chapter.....	67
7. Stakeholders, Corporate Responsibility, and Ethics.....	69
7.1. Stakeholders.....	69
7.2. Corporate Responsibility.....	69
7.3. The Business Case for Corporate Responsibility.....	71
7.4. Ethical and Responsibility Frameworks Used in Europe.....	71
7.5. Corporate Responsibility Trends.....	77
7.6. Obstacles to Corporate Responsibility.....	78
7.7. Board Role in Corporate Responsibility.....	79
7.8. Ethics.....	79
7.9. Tips.....	82
7.10. Summary.....	82
7.11. Resources for This Chapter.....	82
Appendices.....	85
Appendix A: Countries of the Eurozone.....	85
Appendix B: Member States of the EU.....	85
Appendix C: EU Candidate Countries.....	86
Appendix D: Potential Candidate Countries.....	86
Appendix E: Council of Europe Member States.....	86
Appendix F: Members of ecoDa.....	86
Appendix G: Control-Enhancing Methods in Europe.....	87
Boxes.....	
1.1: Definitions of Legislation, Soft Law, and Comply or Explain.....	2
2.1: Royal Ahold.....	10
2.2: Gecina (Spain) and Valeo (France).....	12
2.3: Gertl versus Daimler in Germany (2012).....	13



- 2.4: Royal Dutch Shell plc in the Netherlands and the United Kingdom (2004)..... 13
- 2.5: Royal Bank of Scotland in the United Kingdom (2014) 13
- 2.6: Corpbank and Crédit Agricole Bulgaria (2014)..... 14
- 2.7: MG Rover Group in the United Kingdom (2005) 14
- 3.1: Survey of Baltic Practices20
- 3.2: Applying IFRS in Italy and Germany 22
- 4.1: The Shareholders’ Rights Directive..... 31
- 5.1: Criteria for Determining Director Independence..... 42
- 5.2: Good Practice—ecoDa Principles for Board Composition and Practices 45
- 5.3: Voluntary Code of Conduct for Executive Search (United Kingdom, 2011)..... 47
- 5.4: Examples of Directors’ Duties from Bulgaria and France 49
- 6.1: EU Audit Directive and Regulation 65
- 7.1: The UN Global Compact—10 Principles 72
- 7.2: UN Principles for Responsible Investment 73
- 7.3: OECD Guidelines for Multinational Enterprises 74
- 7.4: Equator Principles 76
- 7.5: A Study of Ethics Codes in the United Kingdom..... 80
- 7.6: Ethical Issues Associated with Company Behavior (United Kingdom) 80
- 7.7: Director Integrity..... 81

Figures

- 3.1: The Integrated Reporting Model..... 23
- 5.1: Three Corporate Governance Models 37

Tables

- 1.1: The Distinctive Character of the EU 2
- 1.2: The Main Initiators of Corporate Governance Changes 6
- 2.1: Percentage of Companies Reporting Significant Related-Party Transactions (2010–2012)..... 11
- 2.2: Workplace Employee Representation in Europe15
- 3.1: Level of Perceived Corruption in European Public Sectors (2013) 21
- 4.1: Structure of Company Ownership in Europe 28
- 4.2: Control-Enhancing Mechanisms In Europe 34
- 5.1: Board Types in Europe 39
- 5.2: Board Size (2013) 41
- 5.3: Proportion of Companies with Combined CEO and Chair (2013) 43
- 5.4: Board-Level Employee Representation in Europe 43
- 5.5: Directors Holding Multiple NED Roles in Public Companies (2013) 44
- 5.6: Percentages of Men and Women Leading Large Companies in the EU 46
- 5.7: Share of Women on Boards of the Largest EU Publicly Listed Companies (January 2012) 46
- 5.8: Proportion of Women on Boards in Some EU Countries (2013) 48
- 5.9: Gender Quotas or Targets 49
- 5.10: Statutory or Case Law Relating to Directors’ Duties 50
- 5.11: Authority to Represent the Company in Enforcing Directors’ Duties 52
- 5.12: Average Numbers of Board Committees (2013) 55
- 5.13: Average Presence of Committees in European Companies (2013)..... 56
- 5.14: Responsibility to Conduct the Evaluation 57
- 7.1: Top-10 Corporate Responsibility Drivers 70
- 7.2: GRI Categories 75
- 7.3: Companies’ Involvement in Corporate Responsibility Activities 77

Foreword

By International Finance Corporation

As one of the most rapidly changing corporate governance environments in the world, Europe represents a microcosm of the exciting innovation happening in the corporate governance arena, ranging from new approaches to board-level corporate governance practices to changes in regulatory requirements at the legislative level.

Representing a diverse mix of nations at various stages of economic development and market maturity, the European Union as an entity is demonstrating the broad value of a prioritized focus on corporate governance while accounting for individual country and company circumstances.

This publication, *A Guide to Corporate Governance Practices in the European Union*, offers an overview of the changes taking place across the EU's corporate governance landscape. It provides a focused examination of specific regulations and practices as well as a frank assessment of the challenges that remain.

The publication also looks at firm-level actions that have improved disclosure and transparency in areas such as accounting accuracy, rights of minority shareholders,

related-party transactions, remuneration, and takeovers. Such changes have yielded significant and positive results, even as some governance-related disputes do continue.

The value of this publication is that it examines the issues from all sides. It assesses the steps forward and steps backward, the progress made and the gaps that remain, presenting the sometimes widely varying perspectives of owners, boards, management, and other stakeholders to create a complete picture of the European corporate governance environment.

IFC has long focused on corporate governance as part of our broader efforts to promote private sector investment, strengthen capital markets, and foster inclusive economic development and growth. We are pleased to partner with the European Confederation of Directors' Associations on this publication, which offers deep insights into effective governance approaches and emphasizes the importance of good corporate governance practices at all levels.

On behalf of IFC, I extend my sincerest thanks to Chris Pierce and the many others who contributed to this valuable guidebook.

*Darrin Hartzler, Global Manager
IFC Corporate Governance Group*

By the European Confederation of Directors' Associations

Corporate governance has changed in recent years to adapt to company practices and regulatory developments. The corporate governance framework now covers a wider range of topics that goes beyond the shareholder-centric approach. The European draft Shareholders' Rights Directive itself tackles subjects that have indirect links to shareholders' rights per se. In general, those more controversial topics currently addressed are often closely linked to political and social choices (gender diversity in boardrooms, employee representation). European and national policymakers need to find ways to resume competitiveness; they need to find better long-term shareholders' engagement and stronger accountability for delegated decision-making power for all corporate actors.

The challenge for them is to define the right remedies without jeopardizing the appropriate "checks and balances" in place among the management, the supervisory bodies, and the shareholders. Another challenge is to define how far they can go in the harmonization of corporate governance in Europe. The risk of imposing a one-size-fits-all approach is that it may potentially undermine the capacity for European companies to innovate and continue to develop best

corporate governance practices that serve their business model and help them define "high road" strategies.

At a time when the new European Commission is in place and the next priorities in corporate governance are to be determined, this publication provides a rigorous analysis of where we stand in Europe in corporate governance. It also illustrates very well all the challenges ahead of us. Chris Pierce presents all the main corporate governance principles and combines them with profound insights. It stimulates a good reflection on how the European Union should distinguish itself in the global economy. Even if most of the challenges are globally shared, how the European Union will address them is crucial for the growth of European companies. We are at a critical point where political input is determinant of our economy.

The European Confederation of Directors' Associations (ecoDa) is truly honored to support this publication. Some of our members have contributed to the reflections, but all the credit goes to Chris Pierce and IFC, who have accomplished a tremendous work that will be without any doubt extremely useful to policymakers, board members, investors, and the business community at large.

Lars-Erik Forsgårdh, Chair, ecoDa

Preface

The purpose of this publication is twofold: to describe the corporate governance framework within the European Union and to highlight good European governance practices. It focuses on the particular aspects of European governance practices that distinguish this region from other parts of the world.

In addition to providing a useful source of reference, this guide is designed to be relevant to anyone interested in the evolving debate about European corporate governance. It should be of particular interest to the following parties:

- Policymakers and corporate governance specialists, to assist in the identification of good practices among the member states. Improvements in corporate governance practices in a country may attract foreign direct investment.
- Directors of listed and unlisted companies, to inspire them to look again at their ways of working.
- Directors of state-owned enterprises (SOEs), to assist in improving corporate governance practices prior to selling off state assets.
- Bankers, to assist in the identification of good corporate governance practices to inform their lending and investing practices.
- Staff within development financial institutions, to assist in the identification of good corporate governance practices that inform their lending, investing, and advisory practices.
- Proxy advisors and legal advisors, to assist in the identification of corporate governance compliance issues.
- Investors, shareholders, stock brokers, and investment advisors, to assist in the identification of good practices in investor engagement and activism.
- Senior company management, to assist in the identification of good relationship-management practices with boards of directors.
- Journalists and academics within business schools, who are interested in good corporate governance practices.
- Private sector and public sector stakeholders from the EU candidate and potential candidate countries in their preparation for eventual accession.

Geographical areas of potential readership may include the following in particular:

- The 18 Eurozone countries (listed in Appendix A);
- The 28 EU member states (Appendix B);
- The five EU candidate countries (Appendix C);
- The three potential candidate countries (Appendix D);
- The 47 European Council Countries (Appendix E); and
- Emerging markets and others seeking to increase trade or attract investment with European countries.

About the IFC Corporate Governance Group

The Group brings together staff from investment support and advisory operations into a single, global team. This unified team advises on all aspects of corporate governance and offers targeted client services in areas such as increasing board effectiveness, improving the control environment, and family businesses governance. The Group also helps support corporate governance improvements and reform efforts in emerging markets and developing countries, while leveraging and integrating knowledge tools, expertise, and networks at the global and regional levels.

About ecoDa

ecoDa's objective is to promote board members' skills, professionalism, and impact on society. By contributing to a professional framework for both current and future board members, ecoDa hopes to help them develop and add value to their organizations, both in the commercial and non-commercial sectors. ecoDa proposes solutions to the key corporate governance questions facing Europe today, including the challenge of helping board members operate effectively across all the European Union member states. ecoDa aims to be an active partner of the European Union and of its institutions—especially the European Parliament and European Commission.

Acknowledgments

Project team: Ralitza Germanova, Associate Operations Officer, IFC Corporate Governance Group; Chris Pierce, CEO, Global Governance Services Ltd, London; Beatrice Richez-Baum, Secretary General, ecoDa; and Philip Armstrong, Senior Advisor, IFC Corporate Governance Group.

We are grateful to everyone who took the time to provide us with insights and information; all responses were instrumental in building the rationale and key thinking points for this publication. Particular thanks to Roger Barker, Director of Corporate Governance and Professional Standards at the Institute of Directors, United Kingdom; Bistra Boeva, Professor, University of National and World Economy, Bulgaria, Bulgarian Corporate Governance Commission, and member of the IFC Private Sector Advisory Group; Leda Condoynanni, General Manager, Hellenic Corporate Governance Council, Greece; Susannah Haan, Secretary General, Europeanissuers; Per Lekvall, Board member of the Swedish Corporate Governance Board; Verica Hadzivasileva Markovska, Board member, Macedonian Institute of Directors; Peter Montagnon, Associate Director, Institute of Business Ethics, United Kingdom, and member of the IFC Private Sector Advisory Group; Oliver Orton, a former Program Manager, IFC Europe and Central Asia, and current Program Manager, IFC

Latin America and the Caribbean; Lutgart Van den Berghe, Executive Director of GUBERNA, Belgium and Extra-Ordinary Professor at the University of Ghent; Merima Zupcevic-Buzadzic, Regional Corporate Governance Lead, IFC Europe and Central Asia; and Patrick Zurstrassen, Honorary Chair, ecoDa, and member of the IFC Private Sector Advisory Group.

Thanks also to (in alphabetical order) Pasquale Di Benedetta, Senior Private Sector Development Specialist, World Bank; Andrea Engel, Senior Country Officer, IFC Brussels; Jeroen Hooijer, Head of Unit, Company Law and Social Responsibility, European Commission; Chris Hodge, Executive Director of Strategy, Financial Reporting Council, United Kingdom; Guray Karacar, Coordinator of Corporate Governance Association of Turkey; Branko Kecman, Board member, Bosnian Institute of Directors; Rezarta Cenaj Melo, Executive Director, Corporate Governance Institute of Albania; Ward Möhlmann, European Commission; Jan Hendrik Ockels, former Vice President, NCD, Institute of Directors, the Netherlands; Irena Prijovic, Secretary General, Slovenian Directors' Association; Lidija Šeškar, Corporate Communication Adviser, Belgrade Stock Exchange; Shannon Roe, who provided editing support; and Wendy Kelly, for designing the publication.



Oesterreichische Entwicklungsbank AG

Preparation and publication of "A Guide to Corporate Governance Practices in the European Union" is made possible with the funding of the Development Bank of Austria (OeEB).

Executive Summary

The European context

For the first time, European Commission Directive 2006/46/EC required all listed companies to produce a corporate governance statement in their annual report to shareholders. Europe 2020 and the EU Action Plan (2012) are examples of the European Commission's published long-term plans for developing corporate governance practices, increasing competitiveness, and developing sustainability among European companies. These and other EU corporate governance reforms have succeeded in bringing about substantial convergence in corporate governance regimes among member states. Yet the EU still faces significant challenges in ensuring that corporate governance initiatives, such as gender diversity and “say on pay,” are well accepted.

The company

Within Europe's public, private, and not-for-profit sectors there exists a wide variety of legal forms of organization. Each sector faces different governance challenges, and specific codes have been developed to identify best-practice principles for each of the sectors. Adopting corporate governance best practices improves competitiveness and can lead to improved access to external financing, a lower cost of capital, improved operational performance, increased company valuation and improved share performance, improved company reputation, and reduced risk of corporate crises and scandals.

The owners

Significant differences exist in investor ownership patterns and engagement practices among shareholders in Europe in the areas of share concentration, share ownership patterns, control-enhancing mechanisms (situations where shareholders increase their control over a company without increasing their proportional stake in shareholding), and the levels of shareholder activity.

Two broad positive implications of concentrated ownership in Europe are that 1) controlling shareholders may be more willing to adopt a longer-term outlook than other investors are, since they can insulate the management from the effects of share price fluctuations and economic cycles; and 2) management can be directly monitored by the owner of the company. This monitoring creates less scope for CEOs to pursue their own private agendas regarding excessive executive remuneration, and it helps avert risky takeovers. Research indicates that controlling shareholders may be more engaged in overseeing the operations of a company than institutional investors are.

However, there also are challenges associated with concentrated ownership in Europe: 1) controlling shareholders may reduce the willingness of institutional investors, foreign investors, and other minority shareholders to invest or engage with companies; 2) minority shareholders may feel vulnerable when investing alongside a controlling shareholder, even when investor protection exists; 3) the board may have little effective power compared to the controlling shareholders; and 4) there may be less emphasis on corporate transparency and disclosure, since the controlling shareholder may be provided with ready access to all company information.

The board

Chapter 5 outlines the characteristics of the unitary, two-tiered, and Nordic boards. You'll find a wide variety of board structures, composition, and practices among European companies. In recent years, board diversity has become an important corporate governance issue, and many European countries have introduced gender quotas in particular. Directors' duties in many countries have been clarified, and there is an increased scrutiny concerning related-party transactions. Board evaluations are becoming increasingly common.

The management

Among European companies there are significant differences in executive powers delegated to management. Remuneration, succession, performance evaluation, and risk management are reviewed in Chapter 6.

Stakeholders, corporate responsibility, and ethics

The role of stakeholders (employees, financiers, suppliers, local communities, and government) varies

considerably across companies, sectors, and countries. In some European countries, the rights of stakeholders are enshrined in company law or other related legislation, such as codetermination and employment-protection legislation. By contrast, companies in other countries have a tradition of focusing more narrowly on the interests of shareholders. Corporate responsibility is becoming more important among European companies, and many companies are developing policies concerning the ethical behavior of their employees.

European Context

The word “Europe” may be used to describe several different entities. For example, it can refer to the 47 member countries of the *Council of Europe* (see Appendix E for details of membership). On other occasions it may be used to refer to the 18 *Eurozone countries* that share the euro currency (Appendix A).

More frequently, the word is used as a collective term to describe the 28 *member states of the European Union* (Appendix B). The population of the European Union is about 490 million people, and the land area is nearly 4.5 million square kilometers. Over time, this membership is likely to grow, with the addition of EU candidate countries (Appendix C) and potential candidate countries (Appendix D). Germany has the largest population, with 80 million people, and Malta has the smallest, with about 400,000 people.

1.1. Why is Europe distinctive?

Although the EU comprises 28 member states that are all extremely proud of their distinctive national identities, the EU has created a region where business cooperation between member states is becoming increasingly common. The distinctive character of the region is listed in Table 1.1 (see page 2).

Europe has become one of the fastest changing corporate governance environments in the world. These governance changes have been caused by many international factors, including the European Commission’s focus on corporate governance.

As an independent supranational authority separate from the member states’ governments, the European Commission has been described as “the only body paid to think European.” Article 17 of the Treaty on European Union identifies the responsibilities of the Commission to



include the following:

- Developing strategies;
- Drafting legislation and arbitrating in the legislative process;
- Representing the EU in trade negotiations;
- Making rules and regulations;
- Drawing up the budget of the European Union; and
- Scrutinizing the implementation of the treaties and legislation.

Originally the driving forces of the European Commission were 1) to cement the single market by creating common standards in governance as in other areas; and 2) to bolster market and public confidence in the wake of the dotcom and other scandals. The European authorities have always seen corporate governance as an important plank of their regulatory program. Thus many commentators suggest that the European Commission does not

Table 1.1: The Distinctive Character of the EU

A large single labor market	The approximately 490 million inhabitants are able to move relatively freely across member states' borders within the EU and work within any member state.
A large single market for goods and services	The EU's residents create a large demand for goods and services. As a result of the abolition of state border controls within the Schengen Countries and States, ^a goods and services can move more freely across borders. Proponents of free movement of goods and services argue that this leads to increased competitiveness.
A single capital market	The EU was created to foster economic cooperation and economic interdependence. As a result of the abolition of border controls within the Schengen Countries and States, capital can move more freely across borders.
A single currency	In 1999, the euro currency came into existence. In 2002, notes and coins began to circulate, and 18 countries within the Eurozone currently now share the same currency (see Appendix A).
Legal standardization	Although the 28 member states have different legal systems, the EU is founded on treaties that have been voluntarily and democratically agreed to by all member states. These binding agreements set out legal principles that all EU governments are required to apply.
A focus on human rights	The core values of the EU are contained in the 2009 Treaty of Lisbon and include respect for human dignity, freedom, democracy, equality, the rule of law, and human rights. The EU's institutions are legally bound to uphold these rights, as are EU governments whenever they apply EU law.
A focus on corporate governance	Since 2003, the European Commission has been active in developing action plans, recommendations, and directives related to corporate governance. Since 2006, all listed companies are required to publish a corporate governance statement in their annual reports.

a. The Schengen Area is named for the 1985 Schengen Agreement and involves participation of 22 of the 28 EU member states. Of the six EU members that do not form part of the Schengen Area, Ireland and the United Kingdom maintain opt-outs, and Bulgaria, Croatia, Cyprus, and Romania are legally obliged to join the area and wish to do so. Also, Iceland, Lichtenstein, Norway, and Sweden have signed the Schengen Agreement. Monaco, San Marino, and the Vatican can be considered to be within the Schengen Area, as they do not have border controls with the countries that surround them, but they have not officially signed documents that make them part of Schengen Agreement.

Source: Chris Pierce.

see corporate governance as value creating, whereas investors and enlightened corporate managements do.

The roadmap for corporate governance in the European Union has been clearly defined in two action plans, published by the European Commission in 2003 and 2012, along with five other proposals and directives. They are listed here in chronological order:

1. EU Action Plan (2003). This plan (European Commission 2003a) was based on a report by the High Level Group of company law experts chaired by Jaap Winter (Winter Report 2002). The plan established four main pillars for corporate governance reforms:

- **Modernizing the board of directors**—The Commission’s recommendations (all adopted in 2005) concerned the following:
 - *Executive versus non-executive directors.* Boards should comprise a balance of executive and non-executive directors so that no individual or group of individuals can dominate decision making. On a unitary board, the chair and CEO roles should be separate; and the CEO should not immediately become chair of either a unitary or a supervisory board.
 - *Independent directors.* A sufficient number of independent directors should be elected to the board of companies to ensure that any material conflict of interest involving directors will be properly dealt with. A director should be considered to be independent only if he or she is free of any business, family, or other relationship—with the company, its controlling shareholder, or the management—that creates a conflict of interest such as to impair his or her judgment.
 - *Directors’ remuneration.* European listed companies should disclose their remuneration policy and remuneration details of individual directors in their annual report.
 - *Collective responsibility.* There should be collective responsibility of all board members for both financial and nonfinancial reporting.
- **Enhancing corporate governance disclosure**—The Commission required all listed companies in the EU to include in their annual report a comprehensive corporate governance statement covering the key elements of their governance structures and practices. This statement should be based on a “comply or explain” principle (that is, it should refer to the

national code of corporate governance and specify which parts of the code the company complies with and explain any deviations). The Commission adopted this recommendation in 2006.

- **Strengthening shareholders’ rights**—The Commission requires that shareholders should have similar rights throughout the EU. In particular, procedural rights involving asking questions, tabling resolutions, voting in absentia, and participating in general meetings were identified as important rights. The Commission also identified problems relating to cross-border voting as needing to be addressed as a matter of urgency. The Commission adopted these recommendations in 2007 in the Shareholder Rights Directive.
- **Coordinating corporate governance initiatives in member states**—These recommendations focused on the development of national corporate governance codes and the monitoring and enforcement of compliance and disclosure.

2. Europe 2020 was launched in 2010 and is the European Union’s 10-year growth and jobs strategy. It sets five headline targets for the EU to achieve by the end of 2020. These cover the following areas:

- Employment;
- Research and development;
- Climate/energy;
- Education; and
- Poverty reduction and social inclusion.

The objectives of the strategy are supported by seven flagship initiatives:

- Innovation;
- The digital economy;
- Employment;
- Youth;
- Industrial policy;
- Poverty; and
- Resource efficiency.

3. EU Action Plan (2012) was adopted in 2012 to increase long-term growth-orientated investment that will lead to more competitive and sustainable companies in the long term. The plan envisages new provisions for reporting on board diversity, risk management, and executive remuneration as well as for improving the quality of corporate governance reports, especially explana-

tions made under the comply-or-explain framework. The following are some of the plan's key measures to enhance transparency:

- **Board structure**—The Commission acknowledged the coexistence of different board models deeply rooted in national legal systems, stating that it would not pursue board-structure harmonization.
- **Shareholder identification and engagement**—The Commission recommended better mechanisms for companies to identify shareholders and to enhance shareholder engagement. The plan strengthens transparency rules for institutional investors, including disclosure of institutional investors' voting and better shareholder control over related-party transactions. The Commission intends to investigate whether employee share ownership should be encouraged.
- **Disclosure**—The Commission recommended that corporate governance reporting be improved, especially concerning explanations for not applying code provisions. This particularly includes the disclosure of board diversity policy, risk-management policies, remuneration policies and individual remuneration of directors, and shareholder voting on the remuneration policy and the remuneration report.

4. Proposal for the revision of the Shareholder Rights Directive (April 2014). The published revisions (European Commission 2014) will tackle certain corporate governance shortcomings, focusing on the behavior of companies and their boards, shareholders (institutional investors and asset managers), and intermediaries and proxy advisors (firms providing services to shareholders, notably voting advice). According to the European Commission, shareholders too often have supported managers' excessive short-term risk taking and have not monitored closely the companies they invested in.

An objective of the proposal is to make it easier for shareholders to use their existing rights over companies and to enhance those rights where necessary. This would help ensure that shareholders become more engaged, do a better job of holding the management of the company to account, and act in the long-term interests of the company. According to the Commission, a longer-term perspective creates better operating conditions for listed companies and improves their competitiveness.

Key elements of the proposal include stronger transparency requirements for institutional investors and asset managers on their investment and engagement policies regarding the companies they invest in, plus a framework

to make it easier to identify shareholders so they can more easily exercise their rights (such as voting rights), in particular in cross-border situations. It would also require proxy advisors to be more transparent on the methodologies they use to prepare their voting recommendations and on how they manage conflicts of interests.

The proposal introduces a European "say on pay" for the first time. The proposal will require companies to disclose clear, comparable, and comprehensive information on their remuneration policies and how they were put into practice. There will be no binding cap on remuneration at the EU level, but each company would have to put its remuneration policy to a binding shareholder vote. The policy would need to 1) include a maximum level for executive pay; 2) explain how it contributes to the long-term interests and sustainability of the company; and 3) explain how the pay and employment conditions of employees of the company were taken into account when setting the policy, including explaining the ratio of executive pay to the pay of average employees.

In October 2014, the European Confederation of Directors' Associations (ecoDa) published a reaction to the proposal (ecoDa 2014), arguing that European institutions should not jeopardize corporate governance structures in companies. The ecoDa paper states that it is essential to keep boards of directors as the central actors and not to disturb the delicate equilibrium between the roles and duties of a shareholders' meeting versus a board of directors in a perhaps unsuccessful effort to cure the intrinsic problem of accountability of the board toward shareholders. It suggests that it is important for boards to retain the leadership in defining the level and the structure of management remuneration, while the remuneration of directors has to be decided by the shareholders. The ecoDa paper argues that it is not realistic to turn inactive shareholders into micromanagers, and that it is doubtful whether the directive will lead to more engagement and long-term thinking from institutional investors.

5. Recommendation on corporate governance reporting (April 2014) aims at improving corporate governance reporting by listed companies.

6. Proposal for a directive on single-member private limited liability companies (April 2014) aims to facilitate the creation of companies with a single shareholder across the EU. It should make it easier for businesses to establish subsidiaries in other member states, as most subsidiaries tend to have only one shareholder—a parent company.

7. Directive on Disclosure of Non-Financial and Diversity Information (April 2014), adopted by the European Parliament, concerns disclosure of nonfinancial and diversity information by certain large companies and groups. It requires companies to disclose information on policies, risks, and outcomes regarding environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity in their board of directors.

The rules will only apply to some large companies with more than 500 employees. In particular, large public-interest entities with more than 500 employees will be required to disclose certain nonfinancial information in their management report. This includes listed companies as well as some unlisted companies, such as banks, insurance companies, and others that are so designated by member states because of their activities, size, or number of employees. The scope includes approximately 6,000 large companies and groups across the EU.

The directive leaves significant flexibility for companies to disclose relevant information in the way they consider most useful or in a separate report. Companies may use international, European, or national guidelines that they consider appropriate (for example, the UN Global Compact, ISO 26000, or the German Sustainability Code).

Many corporate governance commentators believe that the EU corporate governance initiatives have succeeded in bringing about substantial convergence, harmonization, and unification in corporate governance regimes among its member states (Ivaschenko and Brooks 2008). However, some commentators doubt whether this is true. They argue that Swedes still have multiple voting rights, the Spaniards still worry about the inability of shareholders to respond to explanations, the Germans still have two-tier boards, and the United Kingdom allows votes on related-party transactions, which the rest of the EU does not.

The problem for the European Commission has been to design a single system against a background of widely differing legal traditions and ownership structures. Undoubtedly the European Union has come some way toward convergence because of the wide acceptance of *comply or explain*, but it can be argued that there is little agreement in many of the detailed corporate governance practices and norms, and in particular the gulf remains wide between markets with dispersed ownership and those markets with controlling shareholders.

1.2. Legislation, “soft law,” and *comply or explain*

The corporate governance framework for listed companies in the European Union is a combination of legislation and “soft law” (corporate governance codes). Box 1.1 (on page 6) provides brief definitions of the terms *legislation*, *soft law*, and *comply or explain* as used in this guide.

European countries and some international bodies support corporate governance in diverse ways. The following points describe the focus on corporate governance of different entities:

- **EU member states.** Parliaments in all of the 28 member states have introduced or revised their national corporate governance codes in the last 10 years. In 2009, a report by the Commission identified divergences of practices in the context of national governance codes and in particular how they were monitored and enforced (European Commission 2009).
- **EU candidate and potential candidate countries.** Many of the EU candidate and potential candidate countries have been introducing corporate governance laws and regulations to satisfy EU membership conditions.
- **International bodies:** International bodies, such as IFC, International Corporate Governance Network (ICGN) and the Organisation for Economic Co-operation and Development (OECD), have been developing international standards that affect European corporate governance practices.

At a national level, changes in corporate governance codes either have been initiated by the public sector or private sector or have been a mixed initiative. (See Table 1.2 on page 7.) A 2014 survey found that 89 percent of directors in European listed companies believed that compliance with national corporate governance codes was important and a further 9 percent felt that it was somewhat important (Heidrick & Struggles 2014). Different European countries have different levels of compliance, and the newer EU members tend to have the lowest levels of compliance. A survey in Bulgaria, for example found that 79 percent of Bulgarian listed companies complied or explained, 12 percent complied, and 9 percent did not comply or explain (Boeva and Pavlova 2012).

Box 1.1: Definitions of Legislation, Soft Law, and Comply or Explain

Legislation: All of the European jurisdictions have companies acts that regulate the activities of companies. These laws typically draw clear “lines” to distinguish legal from illegal activity.

Soft law: Soft law is typically composed of corporate governance codes that contain “recommendations” for good and responsible governance. Typically, companies are required to report to their shareholders on a comply-or-explain basis.

Comply or explain: If a company chooses to depart from a corporate governance code, the company must explain in its annual report to shareholders which parts of the code it has departed from and why it has done so. A comply-or-explain approach provides companies with flexibility to adapt their corporate governance to their specific situation. Technically, “apply or explain” (associated with the King Reports in Southern Africa) is a more accurate term than “comply or explain,” but it is rarely used in Europe other than in the Netherlands (which is the country that first brought in this expression).

Source: Chris Pierce.

What are the challenges?

Four key corporate governance challenges for Europe have emerged:

- **Finding the right blend of regulation and soft law.** The Commission needs to decide on the mix of formal regulation and comply-or-explain provisions that will deliver the most effective outcomes for companies in their ability to generate wealth and employment over the long term.
- **Boilerplating.** Many European listed companies’ annual reports provide information that does not differ from other companies’ annual reports and is identical from year to year.
- **Weak explanations.** Weak explanations occur when companies deviate from the national code of corporate governance, and the explanation for the deviation under the comply-or-explain regime is often lacking in detail. Several jurisdictions (for example, Belgium, the Netherlands, and the United Kingdom) have published guidelines on the appropriate character of an explanation. An explanation is sufficient if it allows general-public readers to understand which way the company is dealing with a particular issue and why it is doing so. Regarding these weak explanations, the European Commission has concluded that “the information provided is in general unsatisfactory and the oversight by monitoring bodies is insufficient” (European Commission 2012).

Mere references to tradition, to internal agreements, or even to charter provisions are not convincing. —(Wymeersch 2013)

- **Finding the right blend of national and regional regulation.** Some national governments wish to retain law-making authority, and there is therefore some tension between the centralized law making generated by the European Parliament and the Commission.

1.3. Summary

Some commentators have suggested that the EU has a fragmented approach—with several dispersed topical recommendations and directives—that is quite different from the more principle-led approach of the OECD. However, there is general agreement that EU directives have created a solid framework for improving corporate governance in its member states and have triggered many corporate governance improvements. European Commission Directive 2006/46/EC required all listed companies to produce a corporate governance statement in its annual report to shareholders for the first time. This and other EU corporate governance reforms have succeeded in bringing about substantial convergence in corporate governance regimes among its member states.

Yet significant challenges still face the EU in ensuring that the hard and soft laws are well absorbed and become a norm rather than an imposed requirement. The Commission’s Europe 2020 and EU Action Plan (2012) are examples of long-term plans for developing corporate

Table 1.2: The Main Initiators of Corporate Governance Changes

Entities Leading Change	Countries		
Stock Exchanges	Croatia Cyprus Hungary	Italy Latvia Malta	Luxembourg Romania Slovak Republic
Professional Associations	Austria Finland	Lithuania Poland	United Kingdom
Mixed Private Sector Leadership	Netherlands	Slovenia	Sweden
Public Sector	Czech Republic Denmark	Portugal Spain	
Mixed Private and Public Sectors	Belgium Estonia Bulgaria	France Germany Greece	Ireland

Source: Chris Pierce.

governance practices, increasing competitiveness, and developing sustainability among European companies.

1.4. Resources for this chapter

Books, articles, and surveys:

Belcredi, M., and G. Ferrarini, eds. 2013. *Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms*. Cambridge, United Kingdom: Cambridge University Press.

Boeva, B., and V. Pavlova. 2012. *Corporate Governance—State-of-the-art and Future Trends in the Integration of Bulgarian Companies within the European Market*. Sofia, Bulgaria: Publishing Company of University of National and World Economy.

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European Commission. 2003a. *EU Corporate Governance Action Plan*. Brussels: European Commission.

European Commission. 2003b. *Modernising Company Law and Enhancing Corporate Governance in the European Union: A Plan to Move Forward*. COM (2003) 284 Final. Brussels: European Commission.

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European Commission. 2009. *The Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*. Brussels: European Commission.

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- Weil, Gotshal & Manges LLP. 2002. *Comparative Study of the Corporate Governance Codes Relevant to the European Union and its Member States*. Brussels: European Commission.
- Winter, J. (chair). 2002. *Report of the high Level Group of Company Law Experts on Modern Regulatory Framework for Company Law in Europe ("The Winter Report")*. Brussels: European Commission.
- Wymeersch, E. 2013. "European corporate governance codes and their effectiveness." In *Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms*. M. Belcredi and G. Ferrarini, eds. Cambridge: Cambridge University Press.
- Organizations:**
- European Confederation of Directors' Associations*, www.ecoDa.org. ecoDa is a not-for-profit association founded in December 2004 under the laws of Belgium. Its objective is to represent the views of company directors from EU member states to corporate governance policymakers at the EU level. (Its membership is listed in Appendix F.)
- European Corporate Governance Codes Network*, www.ecgn.org. The ECGN is an informal network that exists primarily to share privately the views, experiences, and good practices on issues relating to the corporate governance of European listed companies. The network shares factual information on the content and implementation of national corporate governance codes with European authorities and other interested parties. The ECGN website provides links to European corporate governance codes and national corporate governance bodies.
- European Corporate Governance Institute*, www.ecgi.org. The ECGI focuses on corporate governance research within all of the leading business schools within European universities. The website lists all European corporate governance codes.

Benefits of Good Corporate Governance

Corporate governance focuses on how companies are directed, governed, and controlled. It defines relationships between a company's management, its board, its shareholders, and other stakeholders.

That's one definition of corporate governance among many others, but no matter which definition is used, it is clear that corporate governance should focus on maintaining and developing effective relationships between the key players in a company (shareholders, the board members, and senior executive management) and other key stakeholders. To achieve high-performing economies and impartial societies, companies should base these relationships on three essential elements: efficiency, transparency, and accountability. Corporate governance practices are determined by legislation, listing rules, national corporate governance codes, and board decisions.

2.1. Principles of good governance in European companies

According to ecoDa, good governance is based on a number of widely accepted principles of good governance (ecoDa 2010):

- **Delegation of authority.** European companies should produce a schedule of matters reserved for the board (this sets out the parameters of delegated authority) and a schedule of authorities for executive management (this identifies the financial thresholds regarding decision-making powers).
- **Checks and balances.** Appropriate checks and balances ensure that no one person has unfettered power over decision making. This may include splitting the role of chief executive (leading executive management) from that of the board chair; using a “four eyes” principle when signing contracts or making important commitments on behalf of the company; having an external auditor; and involving independent directors on the board.
- **Professional decision making by an effective team.** European boards are considered key decision-making bodies and so should focus on improving board effectiveness and efficiency.
- **Accountability and transparency.** European companies frequently voluntarily disclose more information than required by law as a means of gaining the confidence and commitment of investors and other external stakeholders.
- **Conflicts of interest.** Directors in European companies are aware that directors are prohibited from directing the activities of the company in favor of themselves or particular shareholders.
- **Aligning incentives.** ecoDa recommends that European companies align incentives in a way that is consistent with the long-term interests of the company.

2.2. Benefits associated with good corporate governance

Numerous studies conclude that well-governed European companies perform better than poorly governed companies (Claessens and Yurtoglu 2012). Adopting corporate governance best practices improves competitiveness and can lead to the following benefits:

- **Improved access to external financing.** Companies with good corporate governance have better access to external financing (particularly from foreign investors) because of higher levels of trust between the providers of capital and executive managers. In Italy, for example, the STAR¹ segment for small and medium enterprises (SMEs), launched in 2001, provides a label of governance quality and transparency for SMEs. STAR businesses have improved access to capital and in particular have higher growth in foreign investment. Whereas in 2001 foreign investors represented 54 percent of investment in STAR companies, in 2011 that number had risen to 88 percent (IFC 2013).
- **A lower cost of capital.** Investors who receive high levels of disclosure from well-governed companies are likely to provide capital to those companies at a lower cost. This willingness to invest reflects the investors' improved knowledge of the company's strategy and expected future performance. The London-based Centre for Economic Policy Research found that good corporate governance has a statistically significant relationship to allocating capital to the most productive opportunities (Claessens, Ueda, and Yafeh 2010).
- **Improved operational performance.** Sustainable wealth creation within the private sector can be achieved only through good management, entrepreneurship, innovation, and better allocation of resources. Effective corporate governance adds value by improving companies' performance through more efficient management and better asset allocation. Bruno and Claessens (2010) found a statistically significant relationship between company performance and good corporate governance practices, particularly the presence of an independent board and board committees.

- **Increased company valuation and improved share performance.** Many researchers have identified the existence of a "corporate governance premium"—an additional price that investors will pay for shares in well-governed companies (Claessens and Yurtoglu 2012). In Italy, for example, since 2009, the STAR governance segment for SMEs has clearly outperformed the Mid Cap index as well as the broader FTSE Italia All-Share Index. Over the 10 years since 2003, FTSE Italia STAR has gained 40 percent, while the FTSE Italia Mid Cap lost 7 percent over the same period, and the FTSE Italia All-Share lost 28 percent (IFC 2013).
- **Improved company reputation.** Many European companies indicate that improvements in corporate governance can lead to increased job satisfaction among employees, higher staff retention, and higher-quality recruitment (BITC 2014).
- **Reduced risk of corporate crises and scandals.** A company with good corporate governance practices will, by definition, have an effective risk-management system that is more likely to cope with corporate crises and scandals. These companies will have implemented processes, such as enterprise risk management procedures, disaster recovery systems, media management techniques, and business continuity procedures. Box 2.1 (on page 11) presents an example of a company that came back from a scandal.

2.3. Challenges related to corporate governance

Companies face a variety of corporate governance challenges. Some, such as related-party transactions, insider trading, and other conflicts of interest, require safeguards to prevent them from occurring. Other challenges involve compliance issues and good practices. Below are brief descriptions of a range of challenges related to corporate governance:

- **Related-party transactions and other conflicts of interest by board members, executives, and senior management.** All European listed companies have adopted International Accounting Standard (IAS) 24 to define related-party transactions and related parties for the purposes of financial reporting. However, in most European countries (apart from

¹ STAR is the market segment of Borsa Italiana's equity market dedicated to midsize companies, with a capitalization of less than €1 billion, that voluntarily adhere to and comply with the following strict requirements: 1) high transparency and high disclosure requirements; 2) high liquidity (free float of at least 35 percent); and 3) corporate governance in line with international standards.

Box 2.1: Royal Ahold

In February 2003, Royal Ahold, a Dutch international retailer, announced a number of accounting irregularities at its subsidiaries. The CEO, CFO, and a number of senior managers resigned as a result, and earnings over 2001 and 2002 had to be restated. As a consequence of the announcements, the company's share price plunged by two-thirds. Dutch law enforcement authorities filed fraud charges against Royal Ahold, which were settled in September 2004, when Royal Ahold paid a fine of approximately €8 million.

Royal Ahold's former CEO, former CFO, and the former executive in charge of its European activities were charged with fraud by the Dutch authorities. In May 2006, a Dutch federal court found Royal Ahold's former CEO and CFO guilty of false authentication of documents, and they received suspended prison sentences and unconditional fines.

A new CEO was appointed in May 2003, and Royal Ahold launched a "road to recovery" strategy in late 2003 to restore its financial health, regain credibility, and strengthen its business. The strategy was a great success, and Royal Ahold restored its financial health through strengthening its accountability, controls, and corporate governance.

Source: A variety of newspaper articles.

the United Kingdom, with its highly dispersed shareholding structures) related-party transactions are among the most commonly heard complaints about corporate behavior. The complaints relate to self-dealing transactions by corporate insiders, which

may be management, directors and/or controlling entities, or shareholders. The percentage of companies that report significant related-party transactions varies widely in Europe, from 0 percent in the Netherlands to 78 percent in Spain. (See Table 2.1.)

Table 2.1: Percentage of Companies Reporting Significant Related-Party Transactions (2010–2012)

Significant related-party transactions (1 percent of revenue or more) within the three years prior to the OECD report in 2012.

Country	% of Companies
Austria	22
France	15
Germany	7
Ireland	47
Italy	8
Netherlands	0
Poland	14
Spain	78
Sweden	2
United Kingdom	5



Source: OECD 2012.

Box 2.2: Gecina (Spain) and Valeo (France)

Gecina (Spain): In 2010, shareholders were asked to approve a related-party transaction involving Spanish-owned Gecina's wholly owned subsidiary, Société des Immeubles de France, and its purchase of a 49 percent stake in Bami Newco. The board authorized the transaction in February 2009. Subsequently the Association for the Defense of Minority Shareholders wrote to the l'Autorité des marchés financiers asking for an inquiry on the financial information disclosed by Gecina, and suggesting that certain transactions would not comply with Gecina's corporate interests, constituting misuse of corporate assets under French law. In the end, based on a vote of disinterested shareholders, the proposed related-party transaction was rejected by 83.7 percent to 16.3 percent. This case was significant in that it was one of the rare instances in which shareholders defeated a related-party transaction.^a

Valeo (France): Shareholders rejected a CEO severance package considered at the Valeo annual general meeting of 2009. In this case, the board had issued an opinion prior to the meeting, stating that it no longer supported the transaction in the light of new information that had emerged (including the fact that the board meeting at which the deal was originally approved had been recorded without board members' knowledge).^b

a. See www.gecina.fr.
b. See www.valeo.com.

Source: A variety of newspaper articles.

The World Bank Doing Business Index has a section on protecting investors. It is based in part on approval and transparency of related-party transactions.² Most European listed companies (with the exception of France) make extensive use of independent board members to approve related-party transactions, sometimes aided by independent experts. Many companies when dealing with related-party transactions require the use of a committee of independent directors, such as an internal control committee or the audit committee, to approve transactions, especially those regarded as material and nonre-current, or on nonmarket terms. However, this does not normally relieve the full board from taking responsibility. In France, independent directors do not have a legal role in approving related-party transactions, and this important role is assigned to the external auditor.

Director liability is often put forward as a means of ensuring that directors, and especially independent directors, fulfill their duties. However, the actual legal liability is quite limited and enforcement is weak (Cheffins and Black 2006). The examples in Box 2.2 are exceptional cases.

- **Insider trading.** In 2014, the European Union adopted the Criminal Sanctions for Market Abuse Directive, which harmonizes criminal sanctions for insider deal-

ing. All EU member states agree to introduce maximum prison sentences of at least four years for serious cases of market manipulation and insider dealing, and at least two years for improper disclosure of insider information. Box 2.3 (on page 13) presents an example of a broad interpretation of insider information.

- **Accurate annual accounts.** Directors are required to provide accurate accounts for shareholder approval at the annual general meeting (AGM), and revisions to financial statements are becoming more frequent. The example in Box 2.4 (on page 13) illustrates the consequences of inaccurate reporting.
- **Nomination/appointment of board members.** These challenges involve disputes between shareholders and the nomination committee and/or the board over nomination/appointment of board members/executives, as well as the criteria for nomination/appointment. The example of Glencore Xstrata in Switzerland and the United Kingdom shows the power of shareholders over appointments: at its AGM in May 2014, 10 percent of Glencore Xstrata shareholders did not support the appointment of Tony Hayward as chair because of the company's failure to appoint any female board members (Armitage 2014).

² See www.doingbusiness.org.

- **Remuneration/bonuses.** These challenges involve disputes between shareholders and the remuneration committee and/or the board over remuneration/bonuses of board members/executives, as well as the criteria for remuneration/bonuses. (See Box 2.5 for an example.)
- **Takeover procedures.** These challenges involve disputes between shareholders and boards regarding terms and conditions of a proposed takeover and/or compliance with internal (articles of association) and/or external (listing rules, securities legislation, and so on) rules. An example is AstraZeneca in the

Box 2.3: Gertl versus Daimler in Germany (2012)

In April 2005, the chair of Daimler, the German car manufacturer, decided that he would tender his resignation prior to the end of his term. In May 2005, he informed the chair of the supervisory board of his intention for the first time. In the following weeks, other members of the supervisory board were informed of this intention. On July 7, 2005, the “presidential commission” (a body within Daimler’s supervisory board) decided to propose that the supervisory board approve the early resignation of the chair and the appointment of a new chair.

On July 28, 2005, the supervisory board decided that the chair would lay down his mandate by the end of the year and that a new chair would be installed. This information was disclosed to the markets on the same day. Following this announcement, the price of Daimler shares increased significantly. However, several investors had already sold their shares prior to the announcement of the decision and took the view that they had been harmed by the late disclosure of the proposed resignation. They filed a complaint against the company and sued for damages.

In a judgment in June 2012, the European Court of Justice confirmed that intermediate steps of a process can qualify as inside information. The implication of the judgment is that European listed companies will need to monitor the risk of inside information more closely (Court of Justice 2013).

Source: Court of Justice 2013.

Box 2.4: Royal Dutch Shell plc in the Netherlands and the United Kingdom (2004)

Royal Dutch Shell plc is an Anglo-Dutch multinational oil and gas company headquartered in the Netherlands and incorporated in the United Kingdom. In 2004, Shell overstated its oil reserves, resulting in loss of confidence in the group, a £17 million fine by the Financial Services Authority, and the departure of the chair. A lawsuit resulted in payment of \$450 million to non-American shareholders in 2007. The risk of inside information will need to be monitored closely (Court of Justice 2013).

Source: Sims 2007.

Box 2.5: Royal Bank of Scotland in the United Kingdom (2014)

EU rules now require banks to ask shareholders for approval of annual bonuses above 100 percent of base salaries. In April 2014, Royal Bank of Scotland abandoned attempts to pay bonuses twice the size of salaries after being told the move would not be approved. UK Financial Investments, the body that manages the U.K. government’s 81 percent stake in the bank, told Royal Bank of Scotland it would veto plans for a 2:1 bonus ratio at the next shareholder meeting.

Source: BBC 2014.

United Kingdom: In May 2014, the U.S. pharmaceutical company Pfizer withdrew its unwelcome takeover offer of £55 a share for U.K. pharmaceutical firm AstraZeneca. The takeover bid was worth £69 billion (BBC 2014b).

- **Minority shareholders' rights.** These challenges involve disputes between majority and minority shareholders in squeeze-out scenarios or on nomination/appointment of board members. (Box 2.6 offers a rather dramatic example.)
- **Mismanagement/bankruptcy/suspension of payments.** These challenges involve disputes between shareholders and/or bond owners and boards and/or receivers in corporate restructuring and disputes between shareholders and boards on alleged mismanagement of the company. (See the example in Box 2.7.)
- **Share/bond issues and share buybacks.** These challenges involve disputes between shareholders/bond owners and boards on dilution issues.
- **Noncompliance with corporate governance codes.** These involve disputes between shareholders and boards on the application of comply-or-explain principles as provided in corporate governance codes. For example, a study for the Commission published in 2009 revealed important shortcomings in applying the comply-or-explain principle that reduce the efficiency of the EU's corporate governance frame-

Box 2.6: Corpbank and Crédit Agricole Bulgaria (2014)

In June 2014, Bulgaria's central bank suspended operations at Corpbank and its recently acquired subsidiary, Crédit Agricole Bulgaria, amid fears that a dispute between its major shareholder and biggest single borrower could trigger the group's collapse. The withdrawals began after Delyan Peevski, a businessman and politician who built a newspaper and television empire on loans approved by Corpbank, claimed in media statements that Tsvetan Vassilev, the bank's largest shareholder, with more than 50 percent of the total shares, planned to kill him!

Within a week, small savers withdrew more than 20 percent of deposits from Corpbank, the country's fourth-largest lender, causing a liquidity crunch that forced the bank's management to seek emergency central bank funding. This situation has had a significant impact on the not-so-small noncontrolling shareholders.

Source: Coppola 2014.

Box 2.7: MG Rover Group in the United Kingdom (2005)

In May 2000, BMW sold Rover to Phoenix, a consortium led by former Rover chief executive John Towers, for £10. It was believed that Phoenix would save thousands of jobs at its factory at Longbridge, Birmingham, which BMW had threatened to close. At the time, Rover was losing £2 million a day. Phoenix took on Rover debt free, aided by a £427 million loan from BMW, repayable in 2049.

In November 2002, MG Rover failed to hit its break-even target, suffering a £95 million loss. In February 2004, it became known that four staff from Phoenix had been paid £31 million for having restructured the firm. BMW branded the Phoenix Four as "the unacceptable face of capitalism" for awarding themselves excessively high salaries despite MG Rover's operating losses that rose to £119 million.

Subsequently, Chinese carmaker Shanghai Automotive worked on a joint venture with Rover to make cars in Shanghai and Longbridge. In April 2005, MG Rover called in the receivers after suppliers refused to deliver to Longbridge and analysis of published accounts revealed £200 million as missing. MG Rover collapsed in 2005, causing 5,000 workers and another 15,000 in the supply chain to face redundancy.

Source: Webb and Griffiths 2009.

Table 2.2: Workplace Employee Representation in Europe

Country	
Austria	Works Council
Belgium	Works Council and Trade Union
Cyprus	Trade Union
Czech Republic	Works Council and Trade Union
Denmark	Trade Union
Estonia	Works Council and Trade Union
Finland	Trade Union
France	Works Council and Trade Union
Germany	Works Council
Greece	Works Council and Trade Union
Hungary	Works Council and Trade Union
Ireland	Trade Union
Italy	Trade Union
Latvia	Trade Union and employee representation
Lithuania	Trade Union and employee representation
Luxembourg	Works Council
Malta	Trade Union
Netherlands	Works Council and Trade Union
Poland	Works Council and Trade Union
Portugal	Works Council and Trade Union
Slovak Republic	Works Council or Trade Union
Slovenia	Works Council and Trade Union
Spain	Works Council and Trade Union
Sweden	Trade Union
United Kingdom	Trade Union

Source: Carly, Baradel, and Welz 2011.

work and limit the system's usefulness. The study revealed in particular that in over 60 percent of cases where companies chose not to apply recommendations, they did not provide sufficient explanation (European Commission 2009).

- **Works council.** A works council represents workers; it functions as local or firm-level complement to national labor negotiations. Works councils have different names and forms in a number of European countries, including the United Kingdom (Joint Consultative Committee), Germany and Austria (Betriebsrat), Luxembourg (Comité Mixte, Délégation du Personel), the Netherlands (Ondernemingsraad), France (Comité d'entreprise), Belgium (Ondernemingsraad/Conseil d'entreprise), and Spain (Comité de empresa). One of the most successful implementations of these institutions is found in Germany. Table 2.2 (on page 15) shows board-level and workplace representation across Europe. Works council disputes can occur between shareholders, boards, and works councils on the interpretation and applicability of worker and trade-union rights.

2.4. Tips

■ Tip 1: Establishment of committees

It is the board's responsibility to ensure that its corporate governance obligations are carried out effectively and efficiently. As a result of the increasing number of corporate governance obligations imposed on European companies, many "Anglo-Saxon-based" companies (particularly in the banking and financial sector since the global financial crisis in 2008) have decided to form the following committees:

- Nomination
- Remuneration
- Risk
- Corporate governance

Companies may need to consider creating these committees to ensure full compliance with their corporate governance obligations. It may be practical for the board to establish a special committee to deal with them on behalf of the entire board. However, in two-tier boards and Nordic boards, which are entirely or predominantly made up of non-executive directors, there is normally little reason to establish special committees for dealing with the company's corporate governance issues. Rather, this is the responsibility of the board as a whole and is normally best handled as such.

■ Tip 2: Enhancing the content of the corporate governance statement

The corporate governance statement in your company's annual report should include the following information:

- Details of related-party transactions and other conflicts of interest involving board members, executives, and senior management;
- Details of remuneration policy and details of individual director remuneration.

■ Tip 3: Relationship management

Your board should consider whether the management of the relationship with key stakeholders needs to be strengthened to reduce the risk of potential disputes and conflicts that could be disruptive to business operations and affect the company's reputation.

2.5. Summary

The last 20 years have seen significant changes in corporate governance practices among EU member states. Many European companies now practice good corporate governance principles. The benefits associated with these practices include greater disclosure and transparency related to the following:

- Accurate accounts
- Minority shareholder rights
- Related-party transactions
- Remuneration
- Takeovers

The EU corporate governance initiatives have led to substantial convergence in corporate governance practices, but governance-related disputes remain common.

2.6. Resources for this chapter

Books, articles, and surveys:

- Armitage, J. 2014. "Glencore Xstrata top management faces investors' anger at AGM." *The Independent* (May 20).
- BBC. 2014a. "RBS plan for 200% bonuses blocked by Treasury body." BBC (April 25).
- BBC. 2014b. "Pfizer drops Astra Zeneca takeover bid." BBC (May 26).
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Organizations:

International Finance Corporation Corporate Governance Group, www.ifc.org/corporategovernance. The Group brings together staff from investment support and advisory operations into a single, global team. This unified team advises on all aspects of corporate governance and offers targeted client services in areas such as increasing board effectiveness, improving the control environment, and family businesses governance. The Group also helps support corporate governance improvements and reform efforts in emerging markets and developing countries, while leveraging and integrating knowledge tools, expertise, and networks at the global and regional levels. IFC's methodology for evaluating corporate governance risks and opportunities has been distilled into the "Corporate Governance Development Framework," a common approach that was adopted by 33 Development Finance Institutions for use in their investment processes.

The Organisation for Economic Co-operation and Development, www.oecd.org. The mission of the OECD is to promote policies that will improve the economic and social well-being of people around the world. The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. First released in May 1999, revised in 2004, and currently under review (2014–2015), the *OECD Principles* is one of the 12 key standards for good corporate governance practices.

The Company

This chapter explores the various types of companies in Europe. It discusses a variety of corporate legal forms within the public, private, and third sectors and identifies the governance challenges that each sector faces. It also addresses the impact of differing tax regimes on the location of incorporation.

3.1. The three sectors

A country's economy can be divided into three sectors: the public, the private, and the third sector. Although in reality the boundaries between these sectors are often fuzzy, the sectors can be defined as follows:

The private sector is that part of a country's economy that is not state controlled and is run by individuals and companies for profit. The private sector encompasses all for-profit businesses that are not owned or operated by the government.

The public sector is the part of a country's economy that is typically a public service, controlled by government authority, and funded by government. It may include central government, local government, and state-owned enterprises.

The third sector is the part of a country's economy that is involved in nongovernmental and not-for-profit activities. It is also known as the nonprofit sector, the voluntary sector, the civic sector, or the community sector. It may include charities, campaigning organizations, trade unions, professional associations, and voluntary organizations.

3.2. Governance and organizational variety within the private sector

For the discussion in this section, certain brief definitions may be helpful:

A joint-stock company is a business entity owned by shareholders. Each shareholder owns a portion of the company proportionate to his or her ownership of the company's shares. This allows for the unequal ownership of a business, with some shareholders owning a larger proportion of a company than others. Shareholders may transfer their shares to others without having any impact on the continued existence of the company.

The existence of a joint-stock company is often synonymous with incorporation (the company has a legal identity separate from shareholders) and limited liability (the shareholders are liable for the company's debts only to the value of the money they invested in the company). Therefore, joint-stock companies are commonly known as corporations or limited liability companies.

Listed companies are limited liability companies that are listed or quoted on public equity markets. The shares of these types of companies are readily bought or sold on a stock exchange.

Unlisted companies are limited liability companies that are not listed or quoted on public equity markets. The scope of unlisted companies is very wide and encompasses start-ups, single owner-manager companies, family businesses, private equity-owned companies, joint ventures, and subsidiary companies. The transfer of shares of these types of companies is more restricted than the transfer of shares in a listed company.

Listed companies

Many of the corporate governance developments in Europe have focused on listed companies, because they typically employ a large proportion of a country's working population and account for a significant percentage of GNP.

Governance challenges facing listed companies

The Virgin Group in the United Kingdom is an example of what can happen when an owner finds outside influences too onerous. Richard Branson delisted the Virgin Group from the London Stock Market in 1988 after he became frustrated with the demands of public shareholders. In 2013, he delisted Virgin Media.

Listed companies are the focus of a great deal of scrutiny as well as answerable to rules and demands imposed by external sources. Here are some of the governance challenges they face:

- They are subject to high levels of regulation and compliance requirements.
- Comply or explain can lead to a focus on specific processes and box-ticking by investors.
- Ownership of shares can quickly change, which can lead to a threat of aggressive and unwanted takeovers.
- It often seems easier to comply through a copy-paste response or to give boilerplate “excuses,” than to think through a tailored approach that would involve more detailed explanations.
- Various organizations (European Commission 2009; ecoDa 2012) have considered what constitutes an adequate and reasonable explanation. Some guidance has been developed at the member-state level, such as from the Belgian Commission.
- The comply-or-explain obligation holds for only part of the codes on corporate governance. It merely focuses on structural, input elements and does not apply to the more “behavioral” and “board dynamics” elements that are crucial to board effectiveness and good governance practices.

In many European countries, small listed companies rely on bank debt, because the majority of their shares are owned by family members who are reluctant to issue shares for fear of diluting their ownership stake in the company. This excessive reliance on bank debt can be detrimental to them, especially in crisis periods (Andres, Caprio, and Croci 2013).

Unlisted companies

Throughout Europe most private sector companies are not publicly listed on regulated equity markets, and they obtain their finance from the bank rather than by selling shares on the stock exchange. Improved corporate governance among unlisted companies has the potential to significantly boost productivity, growth, and job creation in both developed and developing economies. However, despite the large numbers and economic importance of unlisted companies, their governance is an often neglected area of corporate governance studies and recommendations.

For example, in 2013, an estimated 4.9 million businesses in the United Kingdom employed over 24 million people and had a combined turnover of £3.3 trillion. Unlisted SMEs accounted for 99.9 percent of all private sector businesses in the United Kingdom, 59.3 percent of private sector employment, and 48.1 percent of private sector turnover (BIS 2013).

Most unlisted companies in Europe are owned and controlled by single individuals or coalitions of company insiders, such as a family. In many cases, owners continue to play a significant direct role in management. Good governance in this context is not a question of protecting the interests of absentee shareholders. Rather, it is concerned with establishing a framework of company processes and attitudes that add value to the business and help ensure its long-term continuity and success.

Governance challenges facing unlisted companies

Recent research (Andres, Caprio, and Croci 2013) indicates that European family firms generally outperform nonfamily firms. In many respects, unlisted companies face greater corporate governance challenges than listed companies face. Much of the governance framework of listed companies is externally imposed by various types of regulation and formal listing requirements. By contrast, unlisted companies have greater scope to define (or not define!) their own governance strategy. This means that owners of unlisted companies must themselves reflect on the potential costs and benefits of various governance approaches.

Furthermore, in contrast to larger listed enterprises, smaller unlisted entities may not have access to in-house support, such as legal advisors or company secretarial resources, to assist them with important decisions about governance. Determination of the governance framework will largely be a matter for the shareholders and directors, who may need additional specialized governance

expertise, relevant reference frameworks, and tools to help them improve their governance. In 2010, ecoDa developed a set of principles for corporate governance for unlisted companies (ecoDa 2010). These principles provide an important source of reference for all unlisted companies; they can be applied to all such companies in Europe regardless of jurisdiction and legal systems.

3.3. Governance and organizational variety within the public sector

The public sector plays a key economic role as regulator, service provider, and employer. It accounts for more than 25 percent of total employment in Europe and contributes a significant share of economic activity in the EU member states (European Commission 2013). For example, in 2011, Irish government expenditure as a percentage of gross national income was 59.1 percent—the highest level in the EU (Boyle 2012).

The main commercial organizations within the public sector are state-owned enterprises. SOEs are legal entities where the government is a shareholder, and they typically cover infrastructure, railways, defense industry, telecommunications, forestry, ports, airports, nuclear industry, oil and gas, chemistry, and research activities. They are often associated with natural monopolies. There are 870 SOEs within the EU member states.³

SOEs have the dual role of 1) delivering public goods and 2) often employing market-based principles of

operations. In 2005, the OECD developed a set of corporate governance guidelines for state-owned enterprises (OECD 2005), providing an important source of reference for SOEs. Governance practices within SOEs in Europe are often at disappointingly low levels and vary significantly, as the example in Box 3.1 illustrates.

Public sector governance challenges

Public sector entities also face governance challenges, including the following:

- **Complex relationship management:** Public sector governance is often defined as being concerned with three principal relationships: between citizens and the state; between policymakers and the bureaucracy (those responsible for providing public goods and services); and between the bureaucracy as delivery agents and citizens as clients. Thus the role of public sector boards in managing key relationships is more complex than that of private sector boards because of the overlapping nature of these various functions.
- **Strategic goals and objectives:** In the public sector, the profit motive is often reduced (or even absent), and therefore public sector bodies may have a greater tendency to be overstaffed and inefficient. In addition, it is often more difficult to get rid of surplus workers in the public sector than in the private sector. Private businesspeople do not have to worry about political popularity and so are more willing to make people redundant if it helps efficiency.

Box 3.1: Survey of Baltic Practices

A survey (BICG 2012) found considerable public dissatisfaction with the governance practices of SOEs in the Baltic states. In particular, respondents said that the appointment process for board members is opaque: disclosure of information on board members is insufficient for judging their qualifications or forming an opinion on their potential for conflicts of interest.

In general, boards have no formal policies on conflicts of interest or related-party transactions. Nor do they have structures to oversee real or potential conflicts of interest. Many of the boards of SOEs in the Baltic region are fiefdoms of ministries or political parties. Specific criticisms included the following:

- Key director skills are lacking in many cases.
- There is an insufficient number of independent board members and insufficient independent oversight.
- Oversight of the control environment needs to be strengthened. (Board sizes are generally appropriate in all of the countries.)
- No self-evaluations by boards have been conducted in the Baltic region.

Source: BICG 2012.

³ These are 2011 statistics. Figures are not available for Latvia and Lithuania.

- **Crowding out:** An increase in public sector spending can reduce resources for the private sector. For example, if taxes rise to increase government spending, then as a consequence the private sector may have fewer resources for private sector investment. There have been bitter arguments in Europe, with the supporters of austerity saying that if government spending can be reduced it will free up resources for more efficient private sector growth and job creation.
- **Bribery and corruption:** An annual Transparency International survey of corruption focuses on perception levels. As Table 3.1 shows, the level of perceived corruption within European public sectors varies considerably.

3.4. Governance and organizational variety in the not-for-profit sector

In 2010, the Association of Chief Executives in Volun-

tary Organisations (ACEVO) in the United Kingdom published, with other organizations, the second edition of *Good Governance: A Code for the Voluntary and Community Sector* (ACEVO 2010). It is a useful reference for organizations in the not-for-profit sector.

The not-for-profit sector governance challenges

A survey of the top-100 U.K. charities identified the following key challenges facing charities (Grant Thornton 2013):

- Funding cuts;
- Public attitude;
- Not meeting objectives;
- Security of assets or staff;
- Delivery of service;
- Retention of quality of staff;

Table 3.1: Level of Perceived Corruption in European Public Sectors (2013)

Rank	Country	Corruption Perception Index Score (2013) ^a	Rank	Country	Corruption Perception Index Score (2013) ^a
1	Greece	40	15	Portugal	62
2	Bulgaria	41	16	Cyprus	63
3	Italy	43	17	Estonia	68
4	Romania	43	18	Austria	69
5	Slovak Republic	47	19	France	71
6	Croatia	48	20	Ireland	72
7	Czech Republic	48	21	Belgium	75
8	Latvia	53	22	United Kingdom	76
9	Hungary	54	23	Germany	78
10	Malta	56	24	Luxembourg	80
11	Lithuania	57	25	Netherlands	83
12	Slovenia	57	26	Finland	89
13	Spain	59	27	Sweden	89
14	Poland	60	28	Denmark	91

a. A low corruption perception index score indicates low levels of corruption.

Source: Transparency International 2013.

- Information technology/information management;
- Health and safety;
- Performance of investments; and
- Loss of key contracts/finance.

3.5. Transparency and disclosure

Companies in Europe are obliged to have high levels of transparency and disclosure. Transparent disclosure enables stakeholders to gain an informed and accurate view of the company and the way it is doing business. It reduces the scope for unscrupulous companies to conceal unwelcome facts. In 2004, the OECD developed a set of revised Principles of Corporate Governance (OECD 2004), an important reference for international best governance practices. OECD is revising these standards again, with the updated version to be published in 2015.

In Europe, companies should ensure that timely and accurate disclosure is made on all material matters regarding the company, including the financial situation, performance, ownership, and governance of the company. Information should be prepared and disclosed in accordance with high-quality standards of accounting and financial and nonfinancial disclosure. Disclosure should include, but not be limited to, material information on the following:

- The financial and operating results of the company;
- Company objectives;
- Major share ownership and voting rights;
- Remuneration policy for members of the board and key executives and information about board members, including their qualifications, the selection process, other company directorships, and whether they are regarded as independent by the board;
- Related-party transactions;

- Foreseeable risk factors;
- Issues regarding employees and other stakeholders; and
- Governance structures and policies, in particular the content of any corporate governance code or policy and the process by which it is implemented.

Financial reporting

In 2002, the European Union agreed that, starting January 1, 2005, International Financial Reporting Standards (IFRS) would apply for the consolidated accounts of the EU listed companies (European Union 2002). More than 100 countries use IFRS to prepare their financial statements. Box 3.2 provides information from two countries.

In July 2014, the European Commission launched a public consultation on the impact of International Financial Reporting Standards in the European Union. In particular, the Commission aims to examine whether the adoption of IFRS has improved the efficiency of EU capital markets by increasing the transparency and comparability of financial statements.

Narrative nonfinancial reporting

Large European listed and unlisted companies (those with more than 500 employees) are required to extend their diversity and nonfinancial reporting activities on a comply-or-explain basis (European Parliament 2014). The following matters must now be disclosed in the nonfinancial statement:

- Diversity policy in the board of directors;
- Environmental aspects;
- Social and employee-related aspects; and
- Respect for human rights.

ecoDa has identified the following advantages associated with increased nonfinancial reporting (ecoDa 2013):

Box 3.2: Applying IFRS in Italy and Germany

Companies converting to International Financial Reporting Standards find that it involves much more than simply a change in accounting rules. Zambon and Cordazzo (2009) discovered that German and Italian companies' main concern has been to understand the extent to which accounting differences between national Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards affect their reported performance. For example, the findings indicate significant differences in reporting net income. In accounting adjustments, the most significant partial impacts on equity and net income are those concerning the treatment of employee benefits, provisions, intangible assets, and goodwill.

Source: Zambon and Cordazzo 2009.

- It puts more emphasis on the factors that affect the long-term success of enterprises and the main risks incurred. This should help counter the short-termism reigning in numerous investment and hence management circles.
- It balances the attention to financial as well as nonfinancial indicators of performance and success. This is essential to counter the highly biased focus on financial performance (information).
- Such information offers investors and other stakeholders a better insight into the strengths and weaknesses of an enterprise and allows improvement in the dialogue with all interested parties.

ecoDa also identified the following disadvantages and hurdles associated with increased nonfinancial reporting (ecoDa 2013):

- In general, it is difficult to measure a number of qualitative nonfinancial indicators or find generally accepted definitions and measuring techniques.
- The relevant reference data differ from one company to another, from one sector to another, and from one country to another. Moreover, there is the question of how to fit the European nonfinancial reporting proposal within individual countries' corporate governance frameworks, tax requirements, and corporate law.
- The obligation to publish nonfinancial and diversity information might risk fostering a culture of reporting instead of a culture of commitment and engagement. Such additional obligations might seriously increase directors' liabilities. ecoDa contends that the risk of revealing more strategic elements to competitors should be limited and pleads against a wide-ranging, exhaustive reporting obligation. The Confederation also suggests that the proposals should be aligned with the Commission's work in progress on trade/business secrets.

Many leading organizations across Europe are adopting a new integrated reporting model, as shown in Figure 3.1 (on page 24). (For further details, visit www.theiirc.org).

3.6. Challenges associated with corporate reporting

Integrated reporting presents many challenges for the accounting and auditing professions as well as for companies. The following are specific challenges associated with corporate reporting:

- *Shortage of expertise.* The establishment of credible standards for measuring and reporting nonfinancial information is still in a prototype and development phase. The methodologies for providing positive assurance on nonfinancial information are still being developed, and the means for integrating standards and assurance methodologies for financial and nonfinancial information in a way that provides a “true and fair view of an organization's sustainability” have yet to be finalized. To provide professional services in this area, the accounting and auditing professions are likely to require considerable education and training.
- *Cost of producing information.* Companies may experience an increase in the costs of producing corporate reports. The costs of collecting information and obtaining assurance opinions from auditors are likely to increase.
- *Complexity of information.* Many commentators perceive International Financial Reporting Standards as making accounting reports longer and more complex. In particular, they see fair value accounting as very complex, and they believe that non-accounting experts will find it increasingly difficult to understand the valuation of assets on balance sheets.

3.7. Tips

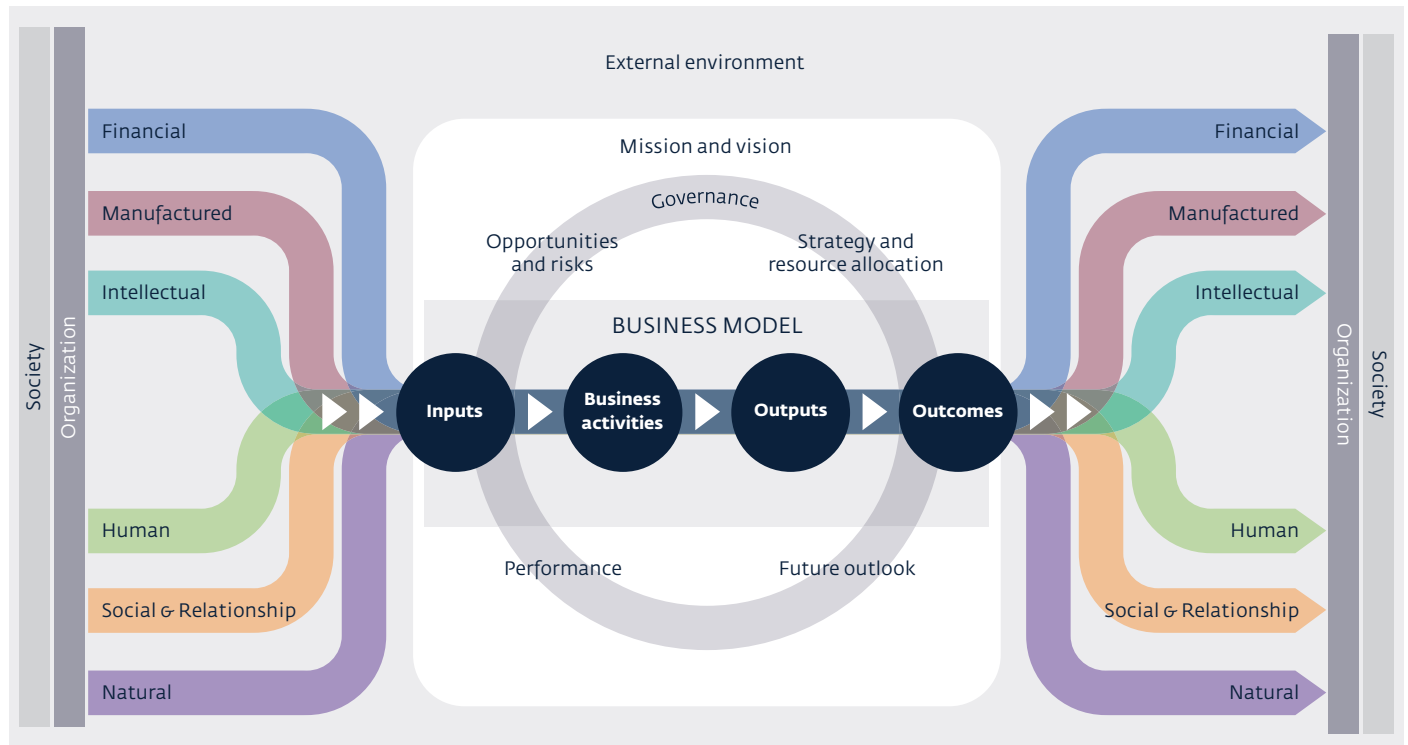
■ **Tip 1: Corporate reporting compliance updates**
Boards within the public, private, or third sector need to keep up to date on governance developments within their sector. In particular, corporate reporting requirements often contain specific sector and organization-size legal obligations. Boards therefore should ensure that they allocate sufficient time to be updated in this area on an annual basis.

■ **Tip 2: Training and development**

Accountants should consider undertaking training and development and continuing professional development in the International Financial Reporting Standards and integrated reporting.

3.8. Summary

A wide variety of organizations exist in the public, private, and third sectors. Each sector faces different governance challenges, and specific codes have been developed to identify best-practice principles for each sector.

Figure 3.1: The Integrated Reporting Model

Source: IIRC 2013.

3.9. Resources for this chapter

Standards:

Companies can rely on standards from different international frameworks, such as the following:

- Global Reporting Initiative.
- International Labour Organization (ILO) Tripartite Declaration on Principles concerning multinational enterprises and social policy;
- ISO 26000;
- OECD Guidelines for Multinational Enterprises;
- UN Global Compact;
- UN Guiding Principles on Business and Human Rights;
- Integrated Reporting; and
- Sustainability Accounting Standards Board.

Books, articles, and surveys:

ACEVO. 2010. *Good Governance: A Code for the Voluntary and Community Sector* (2nd edition). London: Association of Chief Executives of Voluntary Organisations (with CTN, ICSA, and NCVO).

Andres, C., L. Caprio, and E. Croci. 2013. "Restructuring in family firms: A tale of the two crises." In *Boards and Shareholders in European Listed Companies: Facts,*

Context and Post-Crisis Reforms. M. Belcredi and G. Ferrarini, eds. Cambridge: Cambridge University Press.

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- Zambon, S., and M. Cordazzo. 2009. *Accounting Soul Sisters? Implications of IFRS transition for company financial reporting in Italy and Germany*. <http://www.hec.unil.ch/hec/home>.

Organizations:

European Financial Reporting Advisory Group. EFRAG consults on proposals dealing with international financial reporting issues. It comprises a supervisory board of 17 members (plus an observer from the European Commission).

European Securities and Markets Authority, www.esma.europa.eu. ESMA is an independent EU authority that contributes to safeguarding the stability of the European Union’s financial system by ensuring the integrity, transparency, efficiency, and orderly functioning of securities markets, as well as enhancing investor protection.

Fédération des Experts Comptables Européens, www.fee.be. FEE is the representative organization for the accountancy profession of more than 500,000 accountants in Europe.

Federation of European Securities Exchanges, www.fese.eu. FESE represents 42 securities exchanges in Europe.

Institute of Chartered Accountants in England and Wales, www.icaew.com. ICAEW is recognized internationally as a leading contributor to technical excellence and regulatory practice in financial reporting, audit and assurance, corporate governance, business law, tax, corporate social responsibility, and professional ethics.

International Integrated Reporting Council, www.theiirc.org. The mission of the IIRC is to enable integrated reporting to be embedded into mainstream business practice in the public and private sectors.

Principles for Responsible Investment Initiative, www.unpri.org. The UN-supported PRI is an international network of investors working together to put the six Principles for Responsible Investment into practice.

The Owners

This chapter provides an overview of the structure of company ownership in Europe. It discusses the role of active and inactive stock exchanges and the differing powers and rights of shareholders (including dominant block shareholders, minority shareholders, and groups of shareholders). It also addresses shareholder issues associated with pyramids, related-party transactions, and tunneling.

4.1. Stock exchanges in Europe

The European Commission estimates that there are about 10,000 companies listed on Europe's stock exchanges (European Commission 2014). The role of stock exchanges is to provide access to long-term capital. In Europe the role typically includes listing, standards and codes, and monitoring compliance:

- **Listing.** Although the prime responsibility for company listing lies with the stock exchange, in many European countries responsibility is shared between the stock exchange and the securities regulators. In France, for example, the board of directors of Euronext Paris decides on the admission of shares but consults with the *Autorité des Marchés Financiers* and seeks its observations prior to listing. Historically, the function of European stock exchanges has mostly focused on issuing rules and clarifying aspects of existing listing frameworks.
- **Standards and codes.** The standard-setting role of European stock exchanges was exercised through the issuance of listing, ongoing disclosure, maintenance, and delisting requirements. As mentioned in the previous chapter, many of the stock exchanges in Europe have played a leading role in the development of national codes of corporate governance based on comply-or-explain principles.

- **Monitoring compliance.** In addition to overseeing their own rules, in many cases stock exchanges in Europe have been assigned the role of monitoring compliance with legislation and subsidiary securities regulation. Often this is a minor role, since disclosure regimes frequently are not based on stock exchange rules but rather on legislation or regulatory authority rules (such as in the area of accounting standards or takeovers), and so more often than not stock exchanges bring cases to the attention of securities regulators.

In the last 10 years, a dramatic restructuring of stock exchanges has occurred across the world. Here are some examples:

- The combining of NYSE and Euronext in 2006;
- Nasdaq's acquisition of the OMX in 2007;
- Qatar's investment in the London Stock Exchange; and
- The London Stock Exchange's merger with *Borsa Italiana* in 2007.

Competition among stock exchanges has been intensifying, particularly in the areas of trading, listing, and settlement. The European Commission's *Markets in Financial Instruments Directive* in 2007 has led to the development of multilateral trading facilities all over the continent. By

ending “concentration rules” and encouraging competition between traditional exchanges and off-exchange platforms, the directive has prompted rapid development of multilateral trading facilities platforms (for example, Chi-X, Turquoise, and Equiduct) that aim to minimize trading costs for broker-dealers.

Also, the development of “dark pools” has increased competition with stock exchanges. “Dark pool liquidity” is the trading volume created by institutional orders that are unavailable to the public, where institutional investors are granted anonymity, low trading fees, and fast execution of large orders.

4.2. Shareholder rights and powers in Europe

The power of shareholders primarily arises from their ability to appoint, dismiss, and influence the decision making of the board of directors. Such powers may be defined both by company law (which establishes a baseline of shareholder rights) and by the specific contents of a company’s constitutional documents (such as the articles of association or bylaws). In addition, it is common in Europe that shareholders may enter into agreements among themselves that may further define the rights and responsibilities of shareholders (for example, relating to the transferability of shares or the rights of different categories of shareholding).

Basic shareholder rights in Europe include the right to do the following:

- Secure methods of ownership registration;
- Transfer shares;
- Obtain relevant and material information on the company on a timely and regular basis and participate and vote in general shareholder meetings;
- Elect and remove members of the board;
- Share in the profits of the corporation;
- Participate in, and be sufficiently informed on, decisions concerning fundamental corporate changes, such as amendments to the statutes or articles of incorporation or similar governing documents of the company; the authorization of additional shares; and extraordinary transactions, including the transfer of all or substantially all assets, which in effect result in the sale of the company; and
- Participate effectively and vote in general shareholder meetings and be informed of the rules, including voting procedures, that govern general

shareholder meetings, including the following:

- Being furnished with sufficient and timely information concerning the date, location, and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting;
- Having the opportunity to address questions to the board, to place items on the agenda of general meetings, and to propose resolutions;
- Participating in key corporate governance decisions, such as the nomination and election of board members;
- Making their views known on the remuneration policy for board members and key executives; and
- Being able to vote in person or in absentia, with equal effect given to votes whether cast in person or in absentia.

Shareholder rights are generally provided by law, and neither a company nor directors have the power to alter them. The quality of shareholder protection will affect the pattern of share ownership and the efficiency of allocating resources. Where laws and corporate actions protect shareholders and are well-enforced, shares tend to be more valuable.

4.3. The European Model of Share Ownership

The European Model of Share Ownership involves two extreme models, with most European companies positioning themselves somewhere between the two extremes:

- *The insider model* involves shareholders having a very strong engagement and monitoring role with the board. Difficulties with the insider model include private benefits, related-parties transactions, and (potential for) abuse of power. The insider model underscores the need for independent directors and for respecting minority rights.
- *The outsider model* is a dispersed-shareholder model that is typically associated with limited impact of shareholders as well as with institutional capital, a complex investment chain with numerous parties involved, block holdings by institutional investors, and a monitoring focus. Among the difficulties with this model are that engagement depends on the investment policy of the institutional investor, collective action is not straightforward and may be very

Table 4.1: Structure of Company Ownership in Europe

Type of Shareholder	European Average %	Range	Issues
Controlling shareholders	13%	Greece, France, and Germany have a single block shareholder with an ownership stake exceeding 20% in more than 60% of cases. In the United Kingdom, ownership stakes exceed 20% in only about 20% of the companies. ^a	<p>Positive implications:</p> <ul style="list-style-type: none"> Controlling shareholders may be more willing to adopt a longer-term outlook than other investors, since they can insulate the management from the effects of share price fluctuations and economic cycles. Management can be directly monitored by the owner of the company. This creates less scope for CEOs to pursue private agendas in excessive executive remuneration and risky takeovers. Controlling shareholders may be more engaged than institutional investors in overseeing the operations of a company.^b <p>Challenges:</p> <ul style="list-style-type: none"> Controlling shareholders may reduce the willingness of institutional investors, foreign investors, and other minority shareholders to invest or engage with companies. Minority shareholders may feel vulnerable when investing alongside a controlling shareholder, even when investor protection exists. The board may have little effective power compared to the controlling shareholders. There is less emphasis on corporate transparency and disclosure, since the controlling shareholder may have ready access to all company information.
Institutional investors (e.g. domestic pension funds, insurance companies, mutual funds)	Insurance companies & pension funds 12% Investment funds 25%	United Kingdom 41%, France 29%, Austria 29%, Poland 26%, Sweden 25% The rest of the European market is below 15% ^c	In general, institutional investors have played a relatively low and inactive role in the companies they have invested in.
Private nonfinancial companies and organizations	17%	Bulgaria 40%, Germany 40% United Kingdom, less than 2%	This reveals the major differences between the share ownership structure of the United Kingdom and Germany, two of the biggest European markets. In some cases, private nonfinancial companies' ownership of listed shares have been increasing: in Spain, ownership of total shares is 25%; Slovenia, ownership of total shares is 29%; and Germany, ownership of total shares is 39%.

Table 4.1: Structure of Company Ownership in Europe (continued from page 28)

Type of Shareholder	European Average %	Range	Issues
Banks and savings banks	3%		The participation of banks and savings banks in share ownership has been decreasing in some countries (e.g. Spain) and increasing in others (e.g. Germany, France, and the United Kingdom). Banks have generally played a low and passive role in the companies they have invested in.
Public sector ownership	4%		Public sector ownership of listed shares in European markets is particularly high in Norway (31%), Lithuania (27%), and Slovenia (23%), mostly as a result of the partial privatization programs. In most countries in Europe, public sector ownership of listed shares has been in decline and now represents less than 10%, and in seven European stock markets it is almost insignificant at less than 1%.
Foreign investment in European shares	22%		In the United Kingdom, international investors now own more than 50% of U.K. equities. Countries that do not follow the trend are Lithuania and Italy. Italy shows very low levels of foreign ownership, compared to European standards.
Sovereign wealth funds			Sovereign wealth funds (SWFs) have been increasing their stakes in European companies. Examples: Rio Tinto (Aluminum Corporation of China, 12%); Lagardère (Qatar Holding, 10% in 2011); Barclays (Qatar Holding, more than 6% in 2008 and holds warrants for a further 3.2%); Nexus Capital Investing (Abu Dhabi Investment Authority, 6%); Union Bank of Switzerland (the government of Singapore, over 6%); Crédit Suisse (Olayan Group, Saudi Arabia and the State of Qatar both hold over 6%); and Volkswagen (State of Qatar, 17%). Until now, the SWFs have played a small and passive role in the companies they have invested in without exercising any controlling influence on listed companies. However, many commentators raise the concern that SWFs may choose to exercise a more active role on future occasions.
High-frequency trading			In recent years, there has been substantial growth in high-frequency trading by day traders who have no interest in engagement. The Financial Times estimated that 30% of trading in shares in Europe involve high-frequency trading. Firms focused on high-frequency trading rely on advanced computer systems, processing speed of trades, and access to the market. Restrictions on high-frequency trading were introduced in early 2014.

a. La Porta et al. 1998; Barca and Becht 2001; Faccio and Lang 2002.

b. Enriques and Volpin 2007: 121.

c. FESE 2008: 16.

Source: Adapted from Davydoff 2013.

expensive, and acting-in-concert rules may make certain activities illegal.

4.4. The structure of company ownership in Europe

The ownership structure of a company can have significant implications for the relationship between shareholders and directors. Investor profiles within the member states differ and are changing. This section discusses the impact of dispersed and concentrated ownership situations. It also considers the characteristics of pure-risk expectations compared to a social-investor approach. Table 4.1 (on pages 28 and 29) describes company ownership structures in Europe by type of shareholder.

Research indicates that the financial crisis starting in 2008 did not change the share ownership structure dramatically despite acquisitions of stakes by governments and state-owned financial firms (Davydoff 2013). Although there are a number of large mature stock exchanges in Europe, much of the finance for European companies is generated by banks and other financial institutions. Banks currently account for 80 percent of corporate loans. Since the global financial crisis in 2008, banks have been reducing their higher-risk lending, and this is proving to be a problem, particularly for smaller organizations that are now finding themselves competing for scarce funding.

4.5. Shareholder engagement

Shareholder engagement is more than just voting at the general meeting. Shareholder engagement is a purposeful dialogue with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including remuneration. Shareholder engagement (or “stewardship”) aims to promote long-term success of companies. A proactive and constructive relationship between shareholders and the board will increase mutual understanding and commitment, both at times of crisis and during normal business conditions. Generally speaking, effective engagement benefits companies, shareholders, and the economy as a whole.

The European Commission encourages shareholder engagement and attempts to ensure that institutional investors (pension funds, insurers, and so on) and their asset managers act in the best long-term interest of their beneficiaries and clients. This means raising their awareness on the importance of engagement and taking engagement seriously in fulfilling their duties toward their beneficiaries.

If long-term relationships are to be developed, it is important that companies should communicate their strategies to their major shareholders and that their shareholders should understand them. It is equally important that shareholders should play their part in the communication process by informing companies if there are aspects of the business which give them cause for concern. Both shareholders and directors have to contribute to the building of a sound working relationship between them. —(Cadbury 1992)

Two green papers on corporate governance (European Commission 2010 and 2011) reveal that many shareholders are “absent” from companies. On the other hand, on those occasions when shareholders have been active and engaged, the Commission found evidence that many of them pushed banks to take excessive risks rather than to promote the long-term success of the company.

Shareholders with long-term liabilities, such as pension funds or life insurers, are most likely to engage. However, evidence shows that many of these shareholders also have a short-term investment strategy once their funds are being managed by asset managers. Short-term investment strategies focus on turning over the portfolio rather than investing for a long time and engaging on corporate governance matters with investee companies.

This mismatch of interests between asset owners and asset managers has substantially weakened shareholder engagement. The Commission generally accepts that high and increasingly convergent standards across the European Union will help cement the single market and assist in the efficient allocation of capital. The Commission is therefore currently focusing on improving transparency concerning voting and engagement policies.

Improvements

Improving shareholder engagement will include the following:

- **Improved minority shareholder protection.** Given that many European companies have a controlling interest, the protection of minority shareholders’ rights becomes very important. In 2007, the European Commission issued the Shareholders’ Rights Directive. (See Box 4.1 on page 31.)

- **Better oversight of related-party transactions.** The current EU rules⁴ require companies to include in their annual accounts a note on transactions entered into with related parties, stating the amount and the nature of the transaction and other necessary information. Related-party transactions involve situations where companies contract directly with their directors, controlling shareholders, or other related parties. Such transactions may cause prejudice to the company and its minority shareholders, as they give the related party the opportunity to receive large amounts of money at the expense of the company. For this reason, adequate safeguards for the protection of shareholders' interests are of great importance. Material related-party transactions should be approved by shareholders.

Many governance experts regard the current EU requirement as insufficient, and in a recent consultation, a considerable proportion of stakeholders called for stronger safeguards concerning related-party transactions. Therefore, the Commission is currently developing an initiative aimed at improving shareholders' control of related-party transactions, but these proposals are controversial in some member states and may not pass into law. The issue of related-party transactions in some of the candidate countries

has required significant changes to their existing corporate governance regime.

- **Better oversight of remuneration policy.** This improvement involves better transparency in the annual disclosure of remuneration. Recent proposals (European Commission 2014) in Europe will allow shareholders to vote on remuneration policy. In addition, companies in Europe are increasingly required, through their national regulations, to link pay to performance. The goal is for remuneration reports to become more homogenous across the EU.
- **Regulating proxy advisors.** In 2012, the European Commission (European Commission 2012) identified not only a lack of transparency in the preparation of advice by proxy advisors but also perceived conflicts of interest. The Commission is working on addressing the lack of transparency in methods used for the preparation of advice and on improving the framework for preventing conflicts of interest when proxy advisors also act as consultants to investee companies.
- **Clarification of the concept of acting in concert.** Investors in European listed companies are usually required to declare any takeover intentions or place

Box 4.1: The Shareholders' Rights Directive

The key provisions of the Shareholders' Rights Directive set out minimum requirements relating to the holding of meetings:

- A minimum notice period of 21 days for most general meetings, which can be reduced to 14 days if voted electronically and if the general meeting agrees; and Internet publication of the convocation and documents to be submitted to the general meeting at least 21 days before the general meeting;
- The right to put items on the agenda of the general meeting and to table draft resolutions (the minimum stake for filing such rights shall not exceed 5 percent of the share capital);
- Requirements for participation and voting in the general meeting;
- Participation in the general meeting by electronic means, including electronic voting;
- The right to ask questions and the obligation on the part of the company to answer questions;
- The abolition of existing constraints on the eligibility of people to act as proxy holder and of excessive formal requirements for the appointment of the proxy holder;
- Voting by correspondence;
- Disclosure of the voting results on the company's Internet site within 15 days of the general meeting.

In 2014, the Commission announced proposals to make major revisions to the Shareholders' Rights Directive.

Source: European Commission 2007.

⁴ See Art 43(1)(76) 78/660/EEC and Art. 34 (7b) 83/349/EEC. Related-party disclosures are also required by IAS 24 as endorsed into EU law.

a tender offer after acquiring a specific percentage of shares in a company. However, some may try to spread the ownership percentage among friendly parties in an attempt to avoid declaring or bidding. National regulators have determined that, if companies or people are acting in concert and the sum of ownership exceeds the specified percentage, the group must declare its intentions.

- **Employee share ownership.** Employees' interest in the sustainability of their company can contribute to improving governance. Increasing the ratio of long-term employee shareholders reinforces ownership of companies and increases engagement, motivation, and productivity of employees. An external study commissioned by the European Commission in 2014 aims at describing the current situation and at defining the most appropriate methodology to enhance knowledge of employee share ownership schemes and help reduce the cost of designing them.
- **Shareholder identification and dialogue.** The European Commission is encouraging companies to publish additional information on who owns shares. Without the ability to identify shareholders, a company cannot engage with them directly but instead must rely on limited communication by passing information through intermediaries. Improved shareholder identification will enhance the corporate governance dialogue between the company and its shareholders. Also, the monitoring of shareholder-engagement policies mentioned in the new shareholder directive can be effective only if a company's key shareholders have been identified.

Companies need to provide better information about their corporate governance to their investors and society at large. At the same time companies should be allowed to know who their shareholders are and institutional investors should be more transparent about their voting policies so that a more fruitful dialogue on corporate governance matters can take place.

—2010 Action Plan (European Commission 2012)

- **Alignment of incentives of institutional investors.** The transparency of voting and engagement policies adopted by institutional investors and asset manage-

ment firms is increasing (European Commission 2014). The investment and engagement strategies of institutional investors need to be better aligned with the long-term interests of companies they invest in. The incentives in the equity chain (asset managers, asset owners, and ultimate beneficiaries) should also be more aligned. The disclosure of voting and engagement policies of institutional investors is showing some signs of improvement, including development of voting and engagement policies of institutional investors and asset managers, publication of some elements of asset managers' management mandates (portfolio turnover, actual and estimated cost of portfolio turnover), and increased disclosure of the methodology applied and transparency rules by proxy advisors.

Policy objectives

The main policy objectives at the European Commission level are to cause shareholders to be more engaged and thus make companies more sustainable. The following are the main operational objectives:

- **Raise awareness of investors' corporate governance drives**—to achieve improved disclosure of voting policies by institutional investors, thus enabling ultimate investors to optimize investment decisions, facilitating dialogue between investors and companies, and encouraging shareholder engagement.
- **Provide better oversight on remuneration policies and remuneration of managers**—to achieve the harmonization of disclosure requirements and mandatory shareholder voting on the remuneration policy and the remuneration report.
- **Improve shareholder control over management**—to achieve enhancement of shareholder oversight on related-party transactions and to grant shareholders a right of approval for significant transactions.
- **Require better transparency by proxy advisors**—to achieve a focus on the preparation of advice and possible conflicts of interests.

4.6. Say on pay

Say on pay is defined as “the vote of shareholders at a general meeting on the policy and/or various components of compensation of executives and/or non-executives, depending on the country” (IFA 2013). It relates to increased transparency of executive compensation and has been implemented in a variety of versions in many EU member states.

Nearly all of the say-on-pay debate has focused on listed

companies. The European Commission introduced the concept of say on pay into the European Union corporate governance agenda in 2004 (European Commission 2004) and revised it in 2009 (European Commission 2009). The revised version recommends that member states implement the following measures:

- Set a limit of two years maximum of fixed component of director remuneration on severance pay, and ban severance pay in case of failure;
- Require a balance between fixed and variable remuneration, and link variable remuneration to predetermined and measurable performance criteria to strengthen the link between performance and pay;
- Promote the long-term sustainability of companies through a balance between long-term and short-term performance criteria for directors' remuneration, deferment of variable remuneration, a minimum vesting period for stock options and shares (at least three years), and retention of part of the shares until the end of the employment contract;
- Allow companies to reclaim (clawback) variable remuneration awarded on the basis of data that proved to be manifestly misstated;
- Extend certain disclosure requirements contained in the 2004 Recommendation to improve shareholder oversight of remuneration policies;
- Provide that non-executives should not receive share options as part of their remuneration, to avoid conflict of interests;
- Strengthen the role and operation of the remuneration committee through new principles on the following:
 - The composition of remuneration committees;
 - The obligation for the members of the remuneration committee to be present at the general meeting where the remuneration policy is discussed in order to provide explanations to shareholders; and
 - Avoiding conflicts of remuneration consultants.
- Ensure that shareholders, in particular institutional investors, attend general meetings where appropriate and make considerate use of their votes regarding directors' remuneration.

The 2014 proposal for a new shareholder directive includes say on pay as part of a broader agenda to encourage shareholder engagement in their investee

companies (European Commission 2014). The following are perceived benefits associated with say on pay:

- It gives the shareholders control of overall principles for executive remuneration, thus tilting the balance of power more in favor of the shareholders.
- It gives shareholders incentives to become more involved in the governance of companies.

However, there also are possible drawbacks associated with say on pay, such as the following:

- It deprives the board of one of its most powerful instruments for carrying out its fiduciary duties to the shareholders: to hire, fire, and remunerate management.

It is not realistic to turn inactive shareholders into micro-managers. And if the board is not performing its duties the shareholders should dismiss the board, not take over the management of the company. —(Forsgårdh 2014)

- It causes a lack of clarity as to who can be held accountable for bad remuneration decisions.
- “Upward delegation” from the board to the AGM does not necessarily imply better corporate governance.

Say on pay may well be suitable for empowering shareholders and incentivizing them to engage in the governance of companies in jurisdictions where shareholder power and engagement is weak. However, in jurisdictions with strong shareholder power the drawbacks may well override the advantages, leading to worse rather than improved corporate governance standards.

4.7. Control-enhancing mechanisms

Control-enhancing mechanisms (CEMs) are situations where a shareholder can increase control over a company without holding a proportional stake of equity (Shearman & Sterling 2007). A number of mechanisms that allow block holders to enhance control by leveraging voting power are listed in Appendix G. Control-enhancing mechanisms have been a much discussed issue among European policymakers. Table 4.2 (on page 34) shows the use of CEMs in Europe.

4.8. Shareholder engagement with the board

Shareholders can fulfill their role as owners of the company's shares and monitor the value of their assets by taking a regular interest in the life of the company and its strategy. In some cases, individual shareholders engage with companies (or boards) independently or, alternatively, in concert with other shareholders (where such concerted engagement by shareholders is permitted). It is often beneficial for both the company and the shareholders for shareholders to be able to pool resources through collective engagement, especially when the company is facing difficult times (but subject to applicable laws relating to "acting in concert," and to disclosure of their policy on collective engagement), as this can allow for more effective and efficient engagement.

The Commission proposes to improve European companies' contacts with investors, allowing them to be more frequent and intensive than mere attendance at the annual general meeting. The Commission is proposing that institutional investors and asset managers organize to be more actively engaged with investee companies (European Commission 2014).

Shareholder absenteeism

In 2006, the Commission noted that physical shareholder attendance at general meetings varied from 40 percent to 52 percent (European Commission 2006). More recent research (Renneboog and Szilagyi 2013) found that the meeting turnout for the free float⁵ of a company is only 17 percent in France, 10 percent in Germany, and 4 percent in Italy. However, other European countries have much higher rates; for example, in the United Kingdom the turnout rate is 68 percent (Hewitt 2011).

Arguably, low turnout rates in Europe are partly driven by concentrated ownership structures, which have historically remained in place due to poor shareholder protection. Dominant shareholders have strong incentives to attend, participate, and vote in AGMs; however, their presence may exacerbate apathy from minority shareholders, since they perceive that their vote will make little difference (Zetzsche 2008). A 2013 survey concluded that shareholders in Europe use their voice not simply to discipline underperforming managers but also to make up for inefficiencies in the broader governance and institutional environment that potentially lead to many managerial agency problems and underperformance in the first place (Eurofound 2013).

Table 4.2: Control-Enhancing Mechanisms in Europe

Type of CEM	EU Member States with Highest Level of CEMs	EU Member States with Lowest Level of CEMs
Multiple voting share rights	Sweden	United Kingdom
Nonvoting preference shares	United Kingdom	Belgium, France, Spain
Pyramid structures	Sweden	United Kingdom
Priority shares	Netherlands	Belgium, France, Germany, Sweden, United Kingdom
Depository certificates	Netherlands	Belgium
Voting-right ceilings	Spain	Belgium, Netherlands
Ownership ceilings	Greece	Belgium, Spain
Golden shares	Italy	Belgium, Netherlands
Cross-shareholdings	Sweden	Belgium, Greece, Spain, United Kingdom
Shareholders agreements	Italy	Germany

Source: Belcredi and Ferrarini 2003.

⁵ Free float (or public float) is all shares held by investors, other than restricted shares held by company insiders. Free float = outstanding shares – restricted shares.

Effective board-shareholder communication can be enhanced by institutional investors disclosing 1) the full text of the investor's voting policy/guidelines; 2) whether the investor engages the services of proxy advisors; 3) to what extent the investor conducts its own analysis of resolutions before voting; and 4) to what extent the investor follows or diverges from the recommendations of proxy advisors. These disclosures can help the beneficial owners of the shares held by institutional investors understand how investment and voting decisions are made on their behalf. Beneficial owners can then make investment decisions on the basis of whether they want to invest in a fund that brings an independent mind to bear on voting decisions or, alternatively, in a fund that effectively outsources this function to proxy advisors.

4.9. Tips

■ Tip 1: Company constitution (articles of association)

Many companies in Europe regularly revise and update their constitution (articles of association) to clearly articulate shareholders' powers relative to the powers of the board and management. In addition, these revisions often incorporate mechanisms for improving shareholder dialogue and engagement. The time horizons of executive pay are increasingly being aligned with the key time periods for company performance.

■ Tip 2: Remuneration policy and say on pay

Many boards in Europe are increasingly focusing on ensuring that the remuneration policy recognizes that the performance the executives are being rewarded for is aligned with the company's strategic objectives. The review of performance conditions now is often conducted on an annual basis.

■ Tip 3: Remuneration committee

The remuneration committee is receiving more attention concerning how executive pay is structured and how executives have earned the remuneration they receive. The remuneration section within the annual report is now much more carefully crafted.

■ Tip 4: Minority shareholders' rights

Many boards in Europe are increasingly focusing their attention on reducing control-enhancing mechanisms to ensure that minority shareholders' rights are not inhibited.

4.10. Summary

This chapter noted the large variety of investor ownership patterns and practices among shareholders in Europe. It highlighted significant differences between member states in share concentration, share ownership patterns, control-enhancing mechanisms, and levels of shareholder activity. Positive implications of concentrated ownership in Europe include the following:

- Controlling shareholders may be more willing to adopt a longer-term outlook than other investors, since they can insulate the management from the effects of share price fluctuations and economic cycles.
- Management can be directly monitored by the owner of the company. This creates less scope for CEOs to pursue their own private agendas in excessive executive remuneration and risky takeovers. Research indicates that controlling shareholders may be more engaged than institutional investors in overseeing the operations of a company.

However, this chapter also identified the following challenges associated with concentrated ownership in Europe:

- Controlling shareholders may reduce the willingness of institutional investors, foreign investors, and other minority shareholders to invest or engage with companies.
- Minority shareholders may feel vulnerable when investing alongside a controlling shareholder, even when investor protection exists.
- The board may have little effective power compared to the controlling shareholders.
- There may be less emphasis on corporate transparency and disclosure, since the controlling shareholder may be provided with ready access to all company information.

4.11. Resources for this chapter

Standards:

ICGN published the following best-practice statements:

- Model Contract Terms Between Asset Owners and Their Managers (2012);
- Securities Lending Code of Best Practice (2007);
- Statement and Guidance on Gender Diversity on Boards (2013);
- Statement of Global Corporate Governance Principles (2014);

- Statement of Principles for Institutional Investor Responsibilities (2013); and
- Statement of Principles on Institutional Shareholder Responsibilities (2007).

Books, articles, and surveys:

- Barca, F., and M. Becht. 2001. *The Control of Europe*. Oxford: Oxford University Press.
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Organizations:

- Federation of European Securities Exchanges*, www.fese.eu. FESE represents 41 exchanges. At the end of 2013, FESE members had up to 8,950 companies listed on their markets.
- International Corporate Governance Network*, www.icgn.org. The ICGN is a global membership organization of institutional investors who collectively represent funds under management of approximately \$18 trillion.

The Board

Europe is unique in its wide variety of board structures. This chapter examines the varied types of board roles, structures (unitary, two-tier, and Nordic), and powers.

5.1. Diversity of board structures in Europe

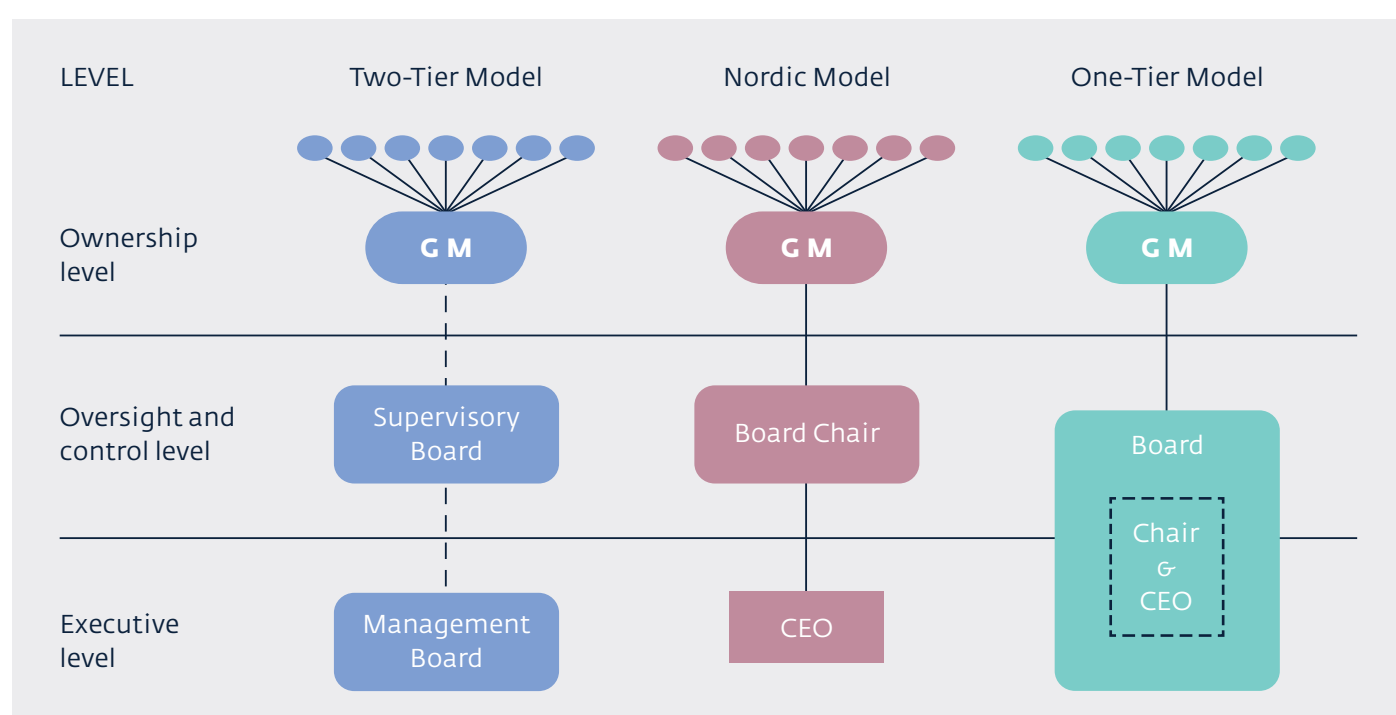
Board structure is important to corporate governance, as it affects the nature and extent of directors' powers, influence, and responsibilities and may also affect the ability of boards to hold managers to account in the running of the company. Board structures in Europe cannot easily be classified. Classification typically divides

companies into a dual system of unitary (one-tier) and two-tier structures, or into three categories: one-tier, two-tier, and Nordic structures. (See Figure 5.1.)

Unitary (one-tier) boards

Unitary boards consist of both executive and non-executive directors. The unitary board is responsible for all aspects of the company's activities, and all the direc-

Figure 5.1: Three Corporate Governance Models



Source: Adapted from Lekvall 2014.

tors have a duty to ensure the prosperity and success of the company. The shareholders elect the directors at the annual general meeting. Eight member states require companies to have a one-tier board structure.

Two-tier boards

Two-tier boards separate executives and non-executives into two separate boards: a management board and a supervisory board. The supervisory board is composed entirely of outside directors, and the management board entirely of executive directors. Members of one board cannot be members of the other, so there is a clear distinction between management and control. The supervisory board oversees the direction of the business, while the management board is responsible for the running of the business. Shareholders appoint members of the supervisory board (other than employee members), while the supervisory board appoints the members of the management board. Seven member states require companies to have a two-tier board.

Nordic boards

Nordic boards have the following key features:

- They are relatively small (in Sweden the average size is 6.5 directors) with a relatively high representation of women (Norway, 42 percent; Sweden and Finland, 27 percent; and Denmark, 16 percent).
- The role of the board is to look after and safeguard the shareholders' assets (the stewardship function).
- The board is entirely or predominantly composed of non-executive directors.
- The roles of chair and CEO are always separated, and there is a strict separation of duties and responsibilities between the board and the CEO. (In Sweden, the law requires this separation to be defined in writing.)
- Board members are normally reelected annually, but they can be dismissed at any time without stated cause.
- There is a right of employee representation on Nordic boards (except in Finland), yet this right is not always exercised.
- The nomination committee is not a committee of the board but rather is a shareholders' committee.

Nordic boards are independent bodies that are strictly subordinate and accountable to the general meeting. Within this framework the board has far-reaching authority to manage the company's affairs as it sees fit to fulfill its fiduciary responsibilities to the shareholders. Table 5.1 (on page 39) shows the board structures by country.

Advantages of one-tier and two-tier boards

In 2014, ecoDa identified the following advantages of a *unitary board* (ecoDa 2014):

- A spirit of partnership and mutual respect exists between directors, which allows greater interaction among board members.
- Non-executive directors have more contact with the company and are more closely involved in the decision-making process.
- Non-executive directors have direct access to information.
- The decision-making process is faster.
- The administrative burden is lighter, as only a single management body needs to hold meetings and only a single set of minutes is needed.

In 2014, ecoDa identified the following advantages of a *two-tier board* (ecoDa 2014):

- There is a clear distinction between supervisory and management functions within the company.
- There is a clear distinction between the liability of members of the supervisory and management bodies.
- Supervisory board members are more independent.
- There is a clear separation of the roles of chair and CEO.

5.2. Board size and composition

Board sizes vary significantly among member states. Also, percentages of independent and non-executive directors, participation of employees on boards, and other elements of board composition differ from country to country. This section examines some of those differences.

Board size

A survey of 15 EU member states found that Finland has the lowest average number of directors per board at 7.5, while Germany, with the inclusion of worker representatives on its supervisory boards, has the highest at 17.0. (See Table 5.2 on page 41.) The survey also found that the shape and structure of boards has remained more or less unaltered over the past decade (Heidrick & Struggles 2014).

Another survey found that variation in board size in Europe is explained by differences in firm characteristics (such as size) and industry characteristics. The study concluded that "country effects do not seem to matter much except for the effect of the rules governing the choice between one-tier and two-tier boards" (Ferreira and Kirchmaier 2013). The same survey found that, since

2007, poorly performing companies have chosen to reduce the size of their boards.

Board composition

The composition of a board includes the types of directors, roles, and who participates and in what ways. European boards range widely in all of those categories.

- **Proportion of executive to non-executive directors.** A non-executive director is a member of a company's board of directors who is not part of the executive team. A non-executive director (NED) typically does not engage in the day-to-day management of the organization but is involved in policymaking and planning exercises. The proportion of executive to non-executive directors varies significantly between member states.

Table 5.1: Board Types in Europe

Country	Board Type
Austria	Mandatory two-tier board structure.
Belgium	One-tier board or mixed structure (the board of directors may transfer some of its power to a "direction committee," which may consist of both directors and non-directors, except for the financial sector, where all members of the direction committee have to be executive directors).
Bulgaria	Choice between one-tier and two-tier board structure. One-tier boards predominate.
Croatia	Choice between one-tier and two-tier board structure. Two-tier boards predominate.
Cyprus	One-tier board structure (although company law does not contain mandatory rules as to a company's board structure).
Czech Republic	Mandatory two-tier board structure.
Denmark	There is a legal choice between the Nordic model and the German-type two-tier board structure; however, no listed company uses the two-tier version.
Estonia	Mandatory two-tier board structure.
Finland	There is a legal choice between the Nordic model and the German-type two-tier board structure; however, only five listed companies use the two-tier version, and this number is decreasing (and the Finnish code advises against the use of it).
France	Choice between one-tier and two-tier board structure. In addition, within the one-tier structure, the company may choose the PDG (président-directeur general) model, which combines the offices of the CEO and the chair of the board. One-tier boards predominate.
Germany	Mandatory two-tier board structure.
Greece	One-tier board structure.

(Table continued on page 40)

Table 5.1: Board Types in Europe (continued from page 39)

Country	Board Type
Hungary	Choice between one-tier and two-tier board structure. Two-tier boards predominate.
Ireland	One-tier board structure (although company law does not contain mandatory rules as to a company's board structure).
Italy	Choice of three different board structures: the "traditional" model with a board of directors and a board of statutory auditors, as well as a typical two-tier and a typical one-tier system.
Latvia	Mandatory two-tier board structure.
Lithuania	Both supervisory board and/or board of directors are optional under Lithuanian law. One-tier boards predominate.
Luxembourg	Choice between one-tier and two-tier board structure. One-tier boards predominate.
Malta	One-tier board structure.
Netherlands	Choice between one-tier and two-tier board structure. Although companies may generally adopt either structure, after exceeding certain size-related thresholds, companies are obliged to adopt a two-tier board. Two-tier boards predominate.
Poland	Mandatory two-tier board structure.
Portugal	Choice of three different board structures (a board of directors and an audit board, as well as a typical two-tier and a typical one-tier system).
Romania	Choice between one-tier and two-tier board structure. Two-tier boards predominate.
Slovak Republic	Mandatory two-tier board structure.
Slovenia	Choice between one-tier and two-tier board structure. Two-tier boards predominate.
Spain	One-tier board structure.
Sweden	Nordic model.
United Kingdom	One-tier board structure (although U.K. company law does not contain mandatory rules as to a company's board structure).

Source: Adapted from Gerner-Beuerle, Paech, and Schuster 2013.

Table 5.2: Board Size (2013)

Country	Average Number of Directors	Country	Average Number of Directors
(2013 European Average)	12.3	Austria	11.8
Germany	17.0	Sweden	11.6
Spain	14.3	Switzerland	10.3
Portugal	14.1	Denmark	10.0
France	14.0	Netherlands	8.6
Italy	14.0	Norway	8.5
Belgium	12.5	Poland	8.3
United Kingdom	12.4	Finland	7.5

Source: Heidrick & Struggles 2014.

Two-tier boards by definition will have 100 percent NEDs on their supervisory boards. A 2014 survey identified Poland as having the lowest proportion of non-executives on listed boards in Europe, at 59 percent (Heidrick & Struggles 2014).

- **Proportion of independent directors.** Director independence is not a concept that can be precisely defined. The European Commission has recommended criteria for determining independence (Box 5.1 on page 42). However, these are only guidelines. Ultimately, it is a matter for the board to determine whether the director is independent in character and judgment, and whether there are relationships or circumstances that are likely to affect, or could appear to affect, the director's judgment. The validity of the criteria needs to be updated annually, and in practice the evaluation of independent attitude should be far more important than compliance with the detailed criteria.

Although there may be differences depending on the country, the boards of larger European companies typically include a sufficient number of non-executive and independent directors to maintain effective board committees; for instance, the audit committee in many countries requires the majority of its members to be independent. Boards should take care to ensure that non-executive or independent appointees have enough time available to devote to the job. This is particularly important for those chairing committees. The letter of appointment should set out the expected time commitment. Non-executive

or independent directors should be sure they will have sufficient time to meet what is expected of them. They should disclose to the board their other significant commitments before their appointment, and they should inform the board of subsequent changes. In general, service on too many boards can interfere with the performance of board members. Companies should consider whether multiple board memberships by the same person are compatible with effective board performance (ecoDa 2010).

It is important for the chair to facilitate the effective contribution of non-executive and independent directors and ensure constructive relations between all directors. Non-executive and independent directors should offer constructive challenges and help develop proposals on strategy. Non-executive directors and independent directors should scrutinize the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

It is advantageous for a board to include independent and non-executive directors. The following are some of the ways they can contribute to the board:

- Bring an outside perspective on strategy and control.
- Add new skills and knowledge that may not be available within the company.
- Bring an independent and objective view that the owner may not have.
- Make hiring and promotion decisions that are independent of family ties.

- Bring an independent view when there may be conflicts of interest within the board.
- Act as a balancing element between the different shareholders (such as family members) and in some cases serve as objective judges of disagreements among family members or managers.
- Bring the benefit of their business connections and other contacts.

According to a survey (Ferreira and Kirchmaier 2013), the number of independent directors on boards increased from 29 percent in 2000 to 34 percent in 2010. The survey results show that both firm size and firm performance are positively related to board independence in European countries.

- *Proportion of boards where CEO and chair roles are combined.* The proportion of boards with a

combined CEO and chair varies among member states. Heidrick & Struggles (2014) reported that the Netherlands has the highest at 68 percent, while the United Kingdom, Germany, Sweden, and Poland are at the low end with 0 percent. (See Table 5.3 on page 43.) The survey also found that 93 percent of directors of European listed companies believed that it is important for the leadership of the chair to encourage excellent team dynamics.

- *Employee participation on European boards.* Systems of employee participation vary widely in European companies. In the German system, for example, employee representatives form 50 percent of the supervisory board in large companies. At the other end of the spectrum is the Dutch system of nomination and opposition rights, where employees are in effect restricted to making recommendations

Box 5.1: Criteria for Determining Director Independence

The European Commission recommends the following criteria for an independent director:

- Cannot be an executive or managing director of a company or an associated company or have been in such a position within the previous five years;
- Cannot be an employee of the company or an associated company or have been in such a position within the previous three years unless elected to the supervisory board as a worker director/representative;
- Cannot receive or have received significant additional remuneration from the company or an associated company apart from a fee received as a non-executive. Such additional remuneration covers in particular any participation in a share option or any other performance-related pay scheme; it does not cover the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the company (provided that such compensation is not contingent in any way on continued service);
- Cannot be or represent the controlling shareholder(s);
- Cannot 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 organizations that receive significant contributions from the company or its group;
- Cannot be or have been within the last three years, partner or employee of the present or former external auditor of the company or an associated company;
- Cannot be an executive or managing director in another company in which an executive or managing director of the company is a 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;
- Cannot have served on the board as a non-executive or supervisory director for more than three terms (or, alternatively, more than 12 years where national law provides for normal terms of a very small length);
- Cannot be a close family member of an executive or managing director of the company.

Source: European Commission 2005.

Table 5.3: Proportion of Companies with Combined CEO and Chair (2013)

Country	% Companies with Combined CEO/Chair	Country	% Companies with Combined CEO/Chair
(2013 European Average)	20	Belgium	10
Netherlands	68	Switzerland	5
Austria	65	Norway	5
France	65	Denmark	5
Spain	31	United Kingdom	0
Italy	18	Germany	0
Finland	15	Sweden	0
Portugal	13	Poland	0

Source: Heidrick & Struggles 2014.

Table 5.4: Board-Level Employee Representation in Europe

Country ^a	Board-Level Representation	Country	Board-Level Representation
Austria	Yes	Latvia	No
Belgium	No	Lithuania	No
Cyprus	No	Luxembourg	Yes
Czech Republic	Yes	Malta	Yes (public companies)
Denmark	Yes	Netherlands	Yes
Estonia	No	Poland	Yes (public companies)
Finland	Yes	Portugal	Yes
France	Yes	Slovak Republic	Yes
Germany	Yes	Slovenia	Yes
Greece	Yes (public companies)	Spain	Yes (public companies)
Hungary	Yes	Sweden	Yes
Ireland	Yes (public companies)	United Kingdom	No
Italy	No		

a. At the time of the survey, Croatia was not a member of the EU.

Source: Carly, Baradel, and Welz 2011.

for the appointment of particular candidates, but shareholders can in turn oppose such nominations. In addition, the employee representatives must not themselves be employees of the company.

Participation of employee representatives in the governance process tends to correlate with a less shareholder-centric understanding of the interests of the company. Board-level representation across Europe is shown in Table 5.4 on page 43.

- **Directors holding numerous NED positions.** It is not uncommon in European public companies for one person to serve as a non-executive director on several boards. Table 5.5 shows the proportion of directors holding three or more NED roles in public companies in Europe in 2013.

Board composition and diversity

The Heidrick & Struggles (2014) survey confirms that board directors value diversity. The survey results show that 97 percent of directors of European listed companies believe that it is important for a board to have the right balance of skills, knowledge, and experience necessary to constructively challenge senior management. The European Confederation of Directors' Associations published a list of principles to help boards achieve balanced board composition. (See Box 5.2 on page 45.)

Recent years have seen a growing focus on increasing board diversity. Greater diversity of directors' backgrounds, skills, and experiences may enhance European

board effectiveness by bringing a wider range of perspectives and knowledge to bear on issues of company performance, strategy, and risk. Commentators suggest that for too long the board has been composed of male, frail (elderly), pale (white), and stale (not up to date) members, and that increasing diversity should be a major imperative for European companies. In addition, some commentators have argued for improving diversity of thought among board members and the avoidance of "group think," where views go unchallenged.

However, the main area of debate in recent years has centered on gender diversity. Diverse boards are more likely to be effective and better able to understand their customers' and stakeholders' needs. A growing body of research has shown that gender diversity is positively associated with the following:

- **Financial performance and shareholder value.** A growing number of studies show a link between more women in senior positions and companies' financial performance. McKinsey (2010) reports that gender-balanced companies have a 56 percent higher operating profit than male-only companies. Ernst & Young (2011) looked at the 290 largest publicly listed companies and found that the earnings of companies with at least one woman on the board were significantly higher than those of companies that had no female board member. We could conclude that getting more women into the labor market is an important factor in improving Europe's economic competitiveness.

Table 5.5: Directors Holding Multiple NED Roles in Public Companies (2013)

Country	% Holding 3 or More NED Roles	Country	% Holding 3 or More NED Roles
(2013 European Average)	11	Norway	13
Switzerland	28	Germany	11
United Kingdom	24	Italy	10
Sweden	23	Denmark	8
Netherlands	22	Austria	7
France	21	Portugal	4
Belgium	17	Spain	1
Finland	15	Poland	1

Source: Heidrick & Struggles 2014.

Box 5.2: Good Practice—ecoDa Principles for Board Composition and Practices

In 2010, ecoDa proposed the following governance principles relating to board composition:

- The board should not be so large as to be unwieldy. The balance of skills and experience should be appropriate for the requirements of the business. Changes to the board's composition should be manageable without undue disruption.
- There should be an explicit procedure for the appointment of new directors to the board. Appointments to the board should be made after careful examination against objective criteria.
- The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management. The aim is to maintain an appropriate balance of skills and experience within the company and on the board.
- The period of appointment of directors should be carefully considered. The board should balance the flexibility of open-ended appointments against the need to ensure planned and progressive refreshing of the board.

Source: ecoDa 2010.

Catalyst (2011) contends that companies that achieve diversity and manage it well attain better financial results, on average, than other companies. Using three measures—return on sales, return on invested capital, and return on equity—to examine financial performance, Catalyst found the following:

- On “return on sales” criteria, companies with the most women board directors outperform those with the least by 16 percent.
- On “return on invested capital” criteria, companies with the most women board directors outperform those with the least by 26 percent.
- Companies with sustained high representation of women on their boards—defined as those with three or more women board directors in at least four of five years—significantly outperformed those with sustained low representation: by 84 percent on “return on sales” criteria, by 60 percent on “return on invested capital” criteria, and by 46 percent on “return on equity” criteria.

However, research (Ahern and Dittmar 2011) on the effects of the 40 percent female quota legislation introduced in Norway indicated that the effect of the female quota caused a drop in the stock market price at the announcement of the law and a decline in asset value over following years. In addition, the research found that the quota led to less-experienced boards and deterioration in operating performance consistent with less-capable boards.

A study by the Credit Suisse Institute found that a

sample of companies with women on their boards outperformed peers that lacked female directors by 26 percent over a period of six years (ICGN 2013).

Adams and Ferreira (2008) found that firm profitability (as measured by return on assets) is positively related to the proportion of women on the boards of European firms. The authors were tempted to conclude that board gender diversity improves firm performance; however, they suggest that an equally plausible hypothesis is that more-profitable and well-governed firms select more women to serve on their boards.

- **Improved board performance.** According to the research by Adams and Ferreira (2008), female directors have better attendance at board meetings, and male directors have better attendance when boards are more gender diverse. Other researchers have noted that greater diversity is associated with a more complex group dynamic in reaching consensus, and that there are higher expectations on the chair to organize an effective discussion.
- **Core values and risk attitude.** Other research (Adams and Funk 2009) revealed that female and male directors differ in their core values and risk attitudes. The researchers found that female directors were more “benevolent and universally concerned” but less power-orientated than men. Women directors were also found to be less traditional and less security-orientated than their male counterparts and were slightly more open to taking

risks than were male directors. The research indicated that having women on the board did not necessarily lead to more risk-averse decision making.

- **Public demand.** Europeans strongly support better gender balance. In a recent Europe-wide opinion poll, 88 percent of respondents said that, given the same qualifications and skills, women should be equally represented in top business jobs, and 75 percent said they were in favor of legislative measures to enforce better gender balance (European Commission 2012b).

In 2012, only 15.8 percent of board members and 16.8 percent of non-executive board members of the largest companies listed on stock exchanges in the 27 member states of the European Union were women, while more than 96 percent of company presidents were men. Consequently, in November 2012, the European Commission proposed a directive that sets a minimum objective of 40 percent women in non-executive board member positions in listed companies in Europe by 2020, and by 2018 for listed public undertakings (European Commission 2012b). The directive is still under scrutiny at the Council of the European Union.

Table 5.6: Percentages of Men and Women Leading Large Companies in the EU

Rank	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Men	98.4	97.4	96.9	96.3	97.1	97.0	97.0	96.6	97.3	96.8
Women	1.6	2.6	3.1	3.7	2.9	2.8	3.0	3.4	2.7	3.2

Source: European Commission 2012a.

Table 5.7: Share of Women on Boards of the Largest EU Publicly Listed Companies (January 2012)

Country	% of Women	Country	% of Women
EU-27	13.7	Lithuania	14.5
Belgium	10.7	Luxembourg	5.7
Bulgaria	15.6	Hungary	5.3
Czech Republic	15.4	Malta	3.0
Denmark	16.1	Netherlands	18.5
Germany	15.6	Austria	11.2
Estonia	6.7	Poland	11.8
Ireland	8.7	Portugal	6.0
Greece	7.4	Romania	10.3
Spain	11.5	Slovenia	15.3
France	22.3	Slovak Republic	13.5
Italy	6.1	Finland	27.1
Cyprus	4.4	Sweden	25.2
Latvia	25.9	United Kingdom	15.6

Source: European Commission 2012a.

Progress on improving the gender balance in Europe's boardrooms has been slow. Even the small increase there can be attributed to calls from the European Commission and European Parliament and a number of national legislative initiatives. France, which introduced legislation on gender balance in boards in 2011, alone accounts for about half of the increase in the EU. But overall, change remains stubbornly slow, and the number of women chairing major company boards in the then-27 EU member states has even declined, falling to 3.2 percent in January 2012 from 3.4 percent in 2010 and a high of 3.7 percent in 2006 (Table 5.6 on page 46).

The share of women on the boards of the largest publicly listed companies is shown in Table 5.7 on page 46. Countries with explicit gender-balance policies, such as Norway, account for most of the gender variation on

Boards should comprise people with different perspectives, backgrounds, and experience. Board renewal is important to ensure a flow of new ideas.

—(ecoDa 2010)

boards. Country characteristics, such as economic development and country size, have been found to have little effect on board gender diversity.

A Heidrick & Struggles (2014) survey found that 63 percent of directors of European listed companies believed that a diverse gender and nationality mix on the board was important. A further 25 percent felt that it was somewhat important.

Box 5.3: Voluntary Code of Conduct for Executive Search (United Kingdom, 2011)

In July 2011, the executive search community in the United Kingdom drew up a voluntary code of conduct to address gender diversity on corporate boards and best practice for the related search processes. To date, 34 leading executive search firms, including all of those dealing with FTSE 100 board appointments, have pledged to abide by the voluntary code. It provides for the following:

- **Succession planning.** Search firms should support chairs and their nomination committees in developing medium-term succession plans that identify the balance of experience and skills they will need to recruit over the next two to three years to maximize board effectiveness. This time frame will allow a broader view to be established by looking at the whole board, not individual hires; this should facilitate increased flexibility in candidate specifications.
- **Diversity goals.** When taking a specific brief, search firms should look at overall board composition and, in the broader context of the board's agreed aspirational goals on gender balance and diversity, explore with the chair whether recruiting women directors is a priority on this occasion.
- **Defining briefs.** In defining briefs, search firms should ensure that significant weight is given to relevant skills and intrinsic personal qualities and not just proven career experience, to extend the pool of candidates beyond those with existing board roles or conventional corporate careers.
- **Long lists.** When presenting their long lists, search firms should ensure that at least 30 percent of the candidates are women—and if not, should explicitly justify to the client why they are convinced that there are no other qualified female options, through demonstrating the scope and rigor of their research.
- **Supporting selection.** During the selection process, search firms should provide appropriate support, in particular to first-time candidates, to prepare them for interviews and guide them through the process.
- **Emphasizing intrinsics.** As clients evaluate candidates, search firms should ensure that they continue to provide appropriate weight to some of the key characteristics, supported by thorough referencing, rather than overvaluing certain kinds of experience.
- **Induction.** Search firms should provide advice to clients on best practice in induction and onboarding processes to help new board directors settle quickly into their roles.

Source: BIS 2013.

Recent European Commission reports on gender

Gender balance is a subject of much study and debate in the EU. The European Commission has issued reports addressing what it sees as a need for greater inclusion of women in company leadership positions. The following are examples:

- **Consultation (2011).** In November 2011, a European Commission consultation (European Commission 2011) revealed that the majority of respondents rejected the idea of requiring listed companies to ensure a better gender balance on the boards through the introduction of a compulsory quota system.
- **Action Plan (2012).** The European Commission (2012a) regards the key issue associated with gender as one of untapped resources. The Plan aims to increase transparency and to have a broader diversity perspective, covering aspects such as age, nationality, and professional and educational background and to be based on the comply-or-explain approach (European Commission 2012c). In a report, the Commission emphasized that just one in seven board members at Europe's top firms is a woman (13.7 percent)—a slight improvement from 11.8 percent in 2010. However, the report pointed out that it would still take more than 40 years to

reach a significant gender balance (at least 40 percent of both sexes) at this current rate of progress.

- **Legislative proposals (2012).** In November 2012, the European Commission published its legislative proposals on the gender balance of listed company boards. There is a proposal for a “minimum objective” of 40 percent representation for each gender among the non-executive directors of listed companies with more than 250 employees and an annual turnover exceeding €50 million. The directive does not apply to SMEs, and neither does it apply to nonlisted entities. Legal opinion is divided as to whether the 40 percent figure is mandatory. Companies that have a less than 40 percent representation will be required to make appointments to those positions on the basis of a comparative analysis of the qualifications of each candidate by applying clear, gender-neutral, and unambiguous criteria. (Also see Box 5.3 on page 47.)

Significant gender disparities still remain on boards in the EU as well as in the candidate and potential candidate countries. The push toward equality today means ensuring that women are not institutionally disadvantaged in their careers, and that they are not “dropping out” at more senior levels in disproportionate numbers due to obstacles they face simply because they are women (European Union Committee 2012).

Table 5.8: Proportion of Women on Boards in Some EU Countries (2013)

Country	% of Women on the Board	% of Boards with No Women Directors	Country	% of Women on the Board	% of Boards with No Women Directors
(2013 European Average)	17	12	Netherlands	19	4
Austria	10	20	Norway	39	0
Belgium	15	15	Poland	8	4
Denmark	17	10	Portugal	8	30
Finland	27	0	Spain	13	14
France	25	3	Sweden	27	0
Germany	16	7	Switzerland	14	15
Italy	11	20	United Kingdom	18	6

Source: Heidrick & Struggles 2014.

Table 5.9: Gender Quotas or Targets

Country	Quota/Target (%)	Expected Date	Current Figures (%)
France	40	2017	25
Norway	40	2008	39
Spain	40	2015	13
Belgium	33	2017	15
Netherlands	30	2015	19
United Kingdom	25	2015	18
Italy	20	2013	11

Source: Heidrick & Struggles 2014.

Table 5.8 on page 48 provides figures on the percentage of women directors—and the percentage of boards with no women directors—in the EU as of 2013. Table 5.9 shows percentage quotas, expected dates, and current figures for EU countries that have gender-balance targets.

5.3. Directors' duties

The regulatory approach to directors' duties differs across Europe. The most obvious source of difference is the variety of systems of statutory rules or general principles of law that are elaborated and amplified by the courts in common law and civil law countries as well as a variety

within some countries, as shown in Table 5.10 on page 50.

However, a recent report conducted by London School of Economics for the European Commission, suggests that “this distinction has lost much of its meaning in the context of directors' duties” (Gerner-Beuerle, Paech, and Schuster 2013). The level of detail with which the duties are laid down also varies considerably between countries. Some jurisdictions, such as in Bulgaria, provide for a largely exhaustive list of specifically defined duties. Other countries, such as France, rely on a general clause that defines the behavioral expectations of directors in broad terms. (See the examples in Box 5.4.)

Box 5.4: Examples of Directors' Duties from Bulgaria and France

In Bulgaria, the Commercial Act lays out specific duties for directors, such as the following:

- Duty of care: s. 237(2)
- Disclosure of conflicts of interest: s. 237(3)
- Noncompetition: s. 237(4)
- Confidentiality: s. 237(5)
- Regulation of related-party transactions: s. 240b

The Public Offering of Securities Act—s. 116b(1)—lays down duties for directors of listed companies. And the Director's mandate includes (s. 280) Obligations and Contracts Act.

In France, the Commercial Code contains Articles 225–251 that apply to the one-tier Société Anonyme (SA) and Articles 225–256, 257, that apply to the two-tier SA. According to 225–251 and 256, directors are liable for the following:

- Infringements of laws
- Breaches of the articles

Source: Bistra Boeva, Bulgarian Corporate Governance Commission and member IFC Private Sector Advisory Group.

Table 5.10: Statutory or Case Law Relating to Directors' Duties

Country	Law	Country	Law
Austria	Statutory law	Italy	Statutory law
Belgium	Mixture: statutory law and case law: <ul style="list-style-type: none"> • Strictly speaking, duties are not codified in company law but are derived from the general duty to act in good faith (Art. 1134, 3, Civil Code) and sections of Companies Code providing for liability of directors • Substantial clarification given by case law (e.g. conditions of liability, coexistence of liability, content of civil law duty to act in good faith) 	Latvia	Statutory law
Bulgaria	Statutory law	Lithuania	Statutory law
Croatia	Statutory law	Luxembourg	Statutory law
Cyprus	Partly case law, partly statutory	Malta	Mainly statutory law
Czech Republic	Statutory law	Netherlands	Mainly statutory law
Denmark	Statutory law	Poland	Partly statutory law, Partly case law
Estonia	Statutory law	Portugal	Statutory law
Finland	Statutory law (case law is used as a reference in the literature and in private practice when interpreting the law)	Romania	Statutory law
France	Partly statutory law, partly general principles	Slovak Republic	Statutory law
Germany	Statutory law	Slovenia	Statutory law
Greece	Statutory Law	Spain	Statutory law
Hungary	Statutory law	Sweden	Statutory law
Ireland	Mainly case law, supplemented by statutory rules on conflicts of interest	United Kingdom	Now statutory law, prior to 2006, common law

Source: Gerner-Beuerle, Paech, and Schuster 2013.

In Europe, directors' duties are owed primarily to the company—that is, to the legal entity and not to its shareholders. However, in some exceptional circumstances duties may be owed directly to shareholders, creditors, or other stakeholders. In the common law countries, directors may owe a duty directly to the shareholders if a “special factual relationship” exists between the director and the shareholders—for example, where directors make direct approaches to the shareholders to induce them to enter into a specific transaction. Duties owed to creditors or to other stakeholders, such as the employees, are not accepted in any of the common law jurisdictions, although the focus of the company's interests may shift from the shareholders to the creditors if the company is moving into insolvency.

In general, the duty of care of a director requires a director to do the following:

- Devote sufficient time, care, and diligence to managing the company;
- Act only on an informed basis;
- Possess the necessary skills and experience to make sound business decisions; and
- Consider the likely outcome of his or her decisions carefully.

All directors have a duty of loyalty and are not to disclose any information of a confidential nature unless required by law to do so. Such information includes the business of the company and any companies in which it holds a stake, which came to their knowledge in their capacity as a director, and which they know or should know is of a confidential nature.

A board member should not use confidential information for personal benefit. At the end of each director's term of office, he or she should return all confidential documents in his or her possession to the company or guarantee their disposal in a manner that ensures that confidentiality is preserved.

If a director intends to disclose to third parties information that may be confidential, he or she must inform the chair of his or her intent and of the identity of the person who is to receive the information. This notice shall be done with sufficient time for the chair to assess the situation and advise the board member. This requirement applies to official and personal statements.

The chair should stress the need for maintaining confidentiality of meeting proceedings. If there are any leaks, the chair should take reasonable steps to identify the

leak but should always stay within the law.

Derivative actions are rare in Europe, and the enforcement levels of director duties are low in all member states (Gerner-Beurele, Paech, and Schuster 2013). Table 5.11 on pages 52 and 53 shows, by country, the differences in authority to represent the company in enforcing directors' duties.

5.4. Directors and conflicts of interest

A conflict of interest is a situation in which someone in a position of trust, such as a company director, has competing professional or personal interests. Such competing interests can make it difficult for directors to fulfill their duties impartially. The reason for avoiding conflicts of interest is to prevent people from seeking personal gain from their position within a company, which can often be to the company's disadvantage.

The board and its members can be subject to conflicts of interests in a number of ways. Directors may represent a major shareholder or other key stakeholder or they may be executive directors. It is essential for the good standing of the organization that such conflicts be recognized and managed in an effective and ethical manner so directors do not profit from their position. Directors are in a position of trust and should exercise their stewardship of the company without regard to any personal gain or avoidance of loss. A conflict of interest may exist even if no unethical or improper act results from it. It can create an appearance of impropriety, which can undermine confidence in the person, profession, or company.

In 2014, the EU Commission proposed some changes in the shareholder directive relating to conflicts of interest (European Commission 2014) in an attempt to address a risk affecting listed companies when they transact business with controlling shareholders. This risk is caused by a lack of transparency and minority shareholder oversight.

ecoDa argues that the Commission's proposal ignores regulatory efficiency as well as business efficiency (ecoDa 2014), contending that extensive regulations already exist in several member states, sometimes with a broader scope that covers other related-party transactions involving directors (especially regarding cross-directorships). Consequently, ecoDa argues that member states will be faced with either dismantling their current procedures or piling up inconsistent regulations. For important transactions—more than 5 percent of assets (cumulative) or significant impact on profit or turnover—the transparency requirements (and independent opinion for transactions above 1 percent of assets) are complemented with an a priori approval by the noninvolved minority shareholders. This

Table 5.11: Authority to Represent the Company in Enforcing Directors' Duties

Country	Company as Claimant	Shareholders in Their Own Name	Third Parties
Austria	Management board Supervisory board	Generally not, except where shareholders enforce personal claims in their own name	Third parties can enforce their own claims
Belgium	General assembly Board of directors	Possible	Creditors can enforce claims
Bulgaria	No clear regulation	If the claim is based on tort law	If the claim is based on tort law
Croatia	Supervisory board in claims against members of the management board	Shareholders can sue, if they suffer damage that is independent from the damage caused to the company	Creditors, if they cannot obtain satisfaction from the company and the directors acted with gross negligence
Cyprus	Board of directors	If their personal rights have been infringed or the company's affairs are conducted in an oppressive manner	No
Czech Republic	Management board	No	No
Denmark	General meeting	Possible	Possible
Estonia	Supervisory board	Possible	Creditors can enforce claims
Finland	Board of directors General meeting	Possible	If the director is liable directly toward them
France	Board of directors	Possible	Possible
Germany	Supervisory board General meeting	Generally not, but the law allows some exceptions	Creditors, if they cannot obtain satisfaction from the company and the directors breached their duties
Greece	Board of directors General meeting	Board of directors General meeting	Creditors can enforce the claims of the company, if they cannot obtain satisfaction from the company
Hungary	Board of Directors	Board of Directors	Creditors, if duties have been violated concerning insolvency

Table 5.11: Authority to Represent the Company in Enforcing Directors' Duties (continued from page 52)

Country	Company as Claimant	Shareholders in Their Own Name	Third Parties
Ireland	Board of directors or resolution by the members	Shareholders can sue in their own name if a breach of a personal duty owed to them is at issue	No
Italy	Board of directors Shareholders Board of auditors Supervisory board	Yes, if the director's action did not harm the company's interests but exclusively affected the rights of the shareholders	Creditors can sue
Latvia	Head of company	No	No
Luxembourg	Board of directors	Possible	Possible
Netherlands	Board of directors	Possible	Possible
Poland	General Meeting	No	No
Portugal	General meeting	Possible	Creditors, if the company or the shareholders fail to enforce claims
Romania	General meeting	Only for claims under tort law	Only for claims under tort law or when the company is in insolvent
Slovak Republic	Supervisory board	No	Creditors, if they cannot obtain satisfaction from the company
Slovenia	General meeting	Generally not, but the law does allow a few exceptions	Creditors, if they cannot obtain satisfaction from the company
Spain	General meeting	Shareholders or third parties can bring a claim for damages against the directors, if the directors have acted in a way that directly harms their interests	Creditors can bring an action, if the company or shareholders do not do so and when the company has insufficient assets to repay its debts
Sweden	General meeting	Shareholders may make a direct claim	Creditors, in certain situations
United Kingdom	Board of directors	Only if a personal right of the shareholders has been invaded	No

Source: Adapted from Gerner-Beuerle, Paech, and Schuster 2013.

raises the question of business efficiency. The proposal for a priori approval of the noninvolved minority shareholders creates the necessity for either a costly additional extraordinary meeting or the need for postponing the transaction until after the next annual general assembly.

Moreover the EU Commission proposal neglects to address the potential of abusing minority positions by giving (small) minorities a veto right in business decisions. If the shareholders consider the transaction to be harmful for the company, thus triggering the board's liability, an a posteriori ratification (one deduced from facts) may provide an efficient safeguard. The Directive's proposal is under discussion at the European Parliament (plenary session in April 2015).

Related-party transactions

Related-party transactions are particularly vulnerable to serious abuse and thus require special supervision by the board. The first obligation of a director is to ensure that any related-party transaction is evaluated impartially and is conducted at "arm's length."

The European Accounting Rules (European Commission 2009a) focus on transactions between related parties other than transactions that would occur with a normal supplier or client/recipient relationship on terms and conditions no more nor less favorable than those that it is reasonable to expect the entity would have adopted if dealing with that individual or entity at arm's length in the same circumstances. The European Accounting Rules provide the following examples of situations where related-party transactions may lead to disclosures by a company:

- Rendering or receiving of services;
- Purchases or transfers/sales of goods (finished or unfinished);
- Purchases or transfers/sales of property and other assets;
- Agency arrangements;
- Leasing arrangements;
- Transfer of research and development;
- License agreements;
- Finance, including loans, capital contributions, grants (whether in cash or in kind), and other financial support, including cost-sharing arrangements; and
- Guarantees and collaterals.

The European Accounting Rules require that the following information about related-party transactions needs to be disclosed:

- A description of the nature of the relationship with related parties involved in these transactions—for example, whether the relationship was one of a controlling entity, a controlled entity, an entity under common control, or key management personnel;
- A description of the related-party transactions;
- A summary of the broad terms and conditions of transactions with related parties, including disclosure of how these terms and conditions differ from those normally associated with similar transactions with unrelated parties; and
- Amounts of outstanding items.

Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary to provide relevant and reliable information for decision-making and accountability purposes. Related parties may include the following:

- Board members of the company, its parent, affiliated or sister companies, and associates;
- A parent, subsidiary, or affiliated company (except 100 percent or wholly owned subsidiaries and parents companies);
- The CEO, general manager, or key officers, including anyone who directly reports to the board or the CEO;
- Any significant shareowner having the ability to control, or exercise a significant influence on, the outcome of resolutions voted on by shareholders or directors of the company, its parent, or affiliated or associated companies;
- The father, mother, sons, daughters, husband, or wife of any of the natural persons listed above;
- Any business—and the directors, CEO, and key officers of any business—in which the natural persons listed above own jointly or severally at least 20 percent of the voting rights; and
- Any person whose judgment or decisions could be influenced as a consequence of an arrangement or relationship between, or involving, themselves and any of the above persons.

The European Corporate Governance Forum, with a mandate that expired in July 2011 (ECGF 2011), developed the following guidelines for all transactions with related parties:

- Transactions representing less than 1 percent of assets should be exempted from any special reporting requirements, although the independent directors should take particular care to satisfy themselves that the transaction is in the best interest of the outside shareholders;
- Transactions with the same related party (or any of its associates) in any 12-month period that have not been approved by shareholders should be aggregated, and if these aggregated transactions exceed 5 percent of assets, then approval should be sought for subsequent transactions;
- Transactions representing more than 1 percent but less than 5 percent of assets should be publicly announced at the time of the transaction, the relevant authority responsible for financial supervision should be notified, and the transaction should be accompanied by a letter from an independent advisor confirming that the transaction is fair and reasonable from the perspective of the outside shareholders;
- Transactions representing more than 5 percent of assets or that have a significant impact on profits or turnover should have the additional requirement of being submitted to a vote by the shareholders in the general meeting but with the related party precluded from voting;
- In all instances, the related party should abstain from any board deliberations about the transaction in question.

These guidelines and definitions may change as a result

of the EU Commission proposals contained in the Shareholder Directive published in 2014.

It is good practice for companies to disclose any actions the board takes to remedy a conflict of interest. The presence of a conflict of interest usually means that the affected board member must abstain from taking part in related discussions and decisions. At the very least, the director in question must excuse himself or herself from the deliberations on that particular agenda item and not vote.

5.5. Committees

The average number of board committees varies significantly among member states. A Heidrick & Struggles (2014) survey of selected European countries identified Poland as having the least, with 2.1, and Germany as having the most, with 4.6. (See Table 5.12.)

The newly introduced EU Audit Directive and Regulations specifies that a majority of the audit committee members must be independent (European Commission 2014):

- At least one member to have competence in auditing and/or accounting; and
- The audit committee as a whole to have competence relevant to the sector in which the company operates.

The Heidrick & Struggles (2014) survey determined the proportion of key committees on boards of European companies, as shown in Table 5.13 on page 56. All listed companies surveyed in Austria, Belgium, France, the Netherlands, Spain, Switzerland, and the United Kingdom had audit and control committees; all listed companies

Table 5.12: Average Numbers of Board Committees (2013)

Country	Average	Country	Average
(2013 European Average)	3.4	Italy	3.3
Germany	4.6	Austria	3.0
United Kingdom	4.4	Belgium	3.0
Switzerland	3.6	Denmark	3.0
France	3.5	Sweden	2.4
Spain	3.5	Finland	2.4
Netherlands	3.4	Norway	2.3
Portugal	3.3	Poland	2.1

Source: Heidrick & Struggles 2014.

Table 5.13: Average Presence of Committees in European Companies (2013)

Committee	% of European Companies
Audit and control committee	96
Remuneration	89
Nomination	73

Source: Heidrick & Struggles 2014.

surveyed in Portugal, Spain, Switzerland, and the United Kingdom had remuneration committees; and all listed companies surveyed in the Netherlands, Sweden, and the United Kingdom had nomination committees. The survey also found that 65 percent of listed companies in France had strategy committees, and that 60 percent of listed companies in Portugal and 65 percent of listed companies in Switzerland had governance committees.

5.6. Board evaluation

Board evaluations are challenging for board members. The evaluation process can be made easier, however, by using facilitators and by treating it as a forward-looking process with the goal of improving the board's performance, rather than as an implicit critique.

Historically, directors have resisted board evaluations, and so evaluations have not been performed. Here are some common reasons why evaluations do not take place:

- Some directors may feel uncomfortable about being evaluated.
- Pressures of day-to-day activities cause the board to delay the evaluation.
- Evaluation might be perceived as a sign that the board lacks trust or confidence in the CEO's performance.
- The directors feel that they lack the skills and expertise to undertake effective evaluations.
- The board has not been emphasizing planning or evaluation; there are no performance targets for the board, committees, or executive managers to measure against.
- The board is dysfunctional.
- The CEO, chair, and/or founder may be dominating the board and might be concerned about the issues that an evaluation may raise.

■ Previous board evaluations were ineffective. Successful board evaluations have a number of common attributes. Here are some typical characteristics of successful evaluations:

- The purpose, objectives, process, and outcomes have been fully explained and discussed with all concerned parties.
- Strict confidentiality is maintained at all times.
- The chair and the CEO play key roles in developing and approving the process.
- It is a regular annual process.
- Benchmarks of board, committee, executive, and company effectiveness are used as performance indicators.
- The evaluation uses a written format that is discussed by all concerned parties.
- The chair provides the full board with a report.
- The process itself is evaluated for improvements to be undertaken in the following year.

The Heidrick & Struggles (2014) survey found that 70 percent of European listed companies undergo a performance evaluation every year, 8 percent undergo one once every two years, 6 percent undergo one once every three years or less often, and 16 percent never undertake one. Table 5.14 (on page 57) shows who has responsibility for conducting the evaluation of the board, the chair, and the CEO.

The same survey revealed that 21 percent of European listed companies use external consultants/facilitators every year, 10 percent use them once every two years, 36 percent use them once every three years or less often, and 33 percent never use one. The survey also found that 78 percent of directors of European listed companies thought a formal board evaluation was important.

5.7. Nomination process

In 2005, the European Commission recommended that all listed companies create a nomination committee composed of a majority of independent directors (European Commission 2005). The nomination and election of board members is one of the fundamental elements of a functioning corporate governance system. It is a basic shareholder right to elect and remove board members. However, contested elections are very rare in Europe.

Nomination practices in Europe vary from country to country. For example, Italy has special voting arrangements to facilitate effective participation by minority shareholders, and in Sweden a block shareholder cannot impose a director over the wishes of the minority shareholders.

5.8. Director induction process

Director orientation is an essential means of providing non-executive directors with the informational building blocks they need to effectively engage in strategic reflection and oversight. Orientation is also important for executive directors, who may come from a functional background and may not yet be used to exercising oversight across the company as a whole. New directors also may want the opportunity to meet fellow board members in advance of the first board meeting. A request for orientation by a new director sends a strong signal that the director is serious about his or her role on the board.

5.9. The board and shareholder engagement

Many European boards engage in communication with shareholders and can do so in a number of different ways:

- **Board oversight of important company and board disclosures.** Communication between the board and shareholders occurs primarily through board oversight of important company and board disclosures to shareholders, including but not limited to prospectuses for securities offerings and periodic financial statements such as the annual report. Although these publications focus predominantly on financial information, there is a growing trend to report on nonfinancial issues, drawing guidance from organizations such as the Global Reporting Initiative (GRI) and the International Integrated Reporting Council (IIRC). Good governance also requires the board to be closely involved in disclosures made by the company regarding the board itself. In this way, directors have the opportunity to educate shareholders on the importance of their work as representatives of all shareholders and on the standards of governance that they uphold.
- **Notice of the annual general meeting or proxy statement.** The notice of the annual general meeting or proxy statement is an important vehicle for shareholder communication. The Shareholder Rights Directive (European Commission 2009b) has the following requirements:
 - A minimum notice period of 21 days, if shareholders agree in a public vote (can be reduced to 14 days if electronic voting is permitted);

Table 5.14: Responsibility to Conduct the Evaluation

Who Evaluates	Board %	Chair %	CEO %
Chair	41	4	30
A committee	13	12	18
Senior/lead independent director	4	14	3
Board members	33	53	52
External consultant/facilitator	17	11	5
Other	4	5	5
No one/not applicable	5	11	6

Note: Percentages in each column may add up to over 100% due to multiple responses.

Source: Heidrick & Struggles 2014.

- Internet publication of the convocation and any documents submitted to the general meeting at least 21 days before the general meeting;
 - Shareholders are provided with sufficient information related to proposed proxy resolutions to be able to make informed decisions on how to vote on those resolutions at the general meeting.
- **Board's response to incoming communication from shareholders.** The board should respond to communication from shareholders. Increasingly, shareholders want their letters to go directly to members of the board rather than being screened by management. To be proactive, boards can provide contact information for the board members who should receive certain types of communication, while at the same time identifying issues that would more appropriately be addressed to management. In some countries, the company secretary can act as an important means of channeling communication.
- **Regular dialogue between significant investors and the company's leaders.** It is important to maintain regular dialogue between significant investors and the company's leaders, not only concerning the annual general meeting but also throughout the year. Directors can work with management to identify the duties of management and the board regarding regular communication with certain investors, such as long-term, major institutional shareholders.
- **Face-to-face meetings.** Boards can remain open and responsive to requests for face-to-face meetings with shareholders, both in the lead-up to the annual general meeting (to discuss and to clarify proposed resolutions to be voted on at the meeting) and throughout the year—particularly with large institutional shareholders. There are various national regulatory barriers to such meetings (notably national regulations prohibiting selective disclosure of material nonpublic information to shareholders and French laws restricting to the CEO the power to commit the company). Nonetheless, these meetings are increasingly important for effective relations between those who govern companies and those who own them.

While in most circumstances it will be more appropriate for shareholders to meet with a member of management, there are likely to be occasions where it will be most effective for a particular member of the board (for example the board chair or the chair of a particular board committee) to engage directly with shareholders, depending on the issue being discussed. In any case, such communication by the chair, CEO,

or lead independent director must follow the positions defined collectively by the board, taking into account, among other things, governance policies and finance and operational discussions.

- **Ensuring that shareholder communication reaches all shareholder groups, using the same means.** In a company with a concentrated ownership, the key role of the board with regard to shareholders is to heed the interests of all of them—not just the dominant ones—as issues pertaining to equal treatment and selective disclosure may arise. For example, shareholders with representatives on the board do enjoy access to more information, but those representatives are still bound by the fiduciary duty of directors to all shareholders. Boards of such companies need to ensure that shareholder communication reaches all shareholder groups, using the same means of communication, but with appropriate attention to specific needs of each shareholder group.

One of the important benefits of these meetings is that they provide an opportunity for the board to hear any concerns and issues that the shareholders may have. It is rare in these discussions for anyone other than the CEO to commit the company or to transmit price-sensitive information, because the shareholders are communicating with the directors rather than vice versa. This sort of discussion is to be encouraged, especially when there is a block shareholder.

5.10. Director and board development

European member states have been witnessing a growing demand for director- and board-development activities. Most of the European countries have expanding director institutes that aim to improve the professionalism of directors. Some of the institutes, such as the United Kingdom Institute of Directors, have developed certification, or are in the process of doing so, as a good way to enhance directorship as a profession and further promote sound corporate governance.

In some markets the director-training institute maintains a database of certified directors, and companies can subscribe to it. For example, the Slovenian Directors Association invites any member who holds a position on a supervisory board of a listed company to become a “chartered supervisory board member” by passing an examination. All candidates who successfully complete the examination are listed in a national register of supervisory board members.

5.11. Tips

■ **Tip 1:** The board should maintain a schedule of matters reserved for the board

An indicator of good governance is a company that has a schedule of matters reserved for the board. A schedule would typically include the following:

- Definition of corporate goals, strategy, and structure;
- Responding to shareholders and third parties;
- Supervising and controlling company progress;
- Supervising the chief executive or managing director;
- Approval of corporate plans;
- Approval of operating and capital budgets;
- Approval of major corporate actions (for example, acquisitions, disposals, commencing or terminating of business activities);
- Approval of financial statements;
- Approval of borrowings or creditor guarantees (possibly above a certain amount);
- Policy on external communication, such as with regulators, shareholders, or the media;
- Definition of authority delegated to management; and
- Nomination and dismissal of the managing director/CEO and a say on his or her remuneration (possibly also of other top management, in consultation with the CEO).

■ **Tip 2:** The board should maintain a related-party transactions policy

For the board to exercise proper oversight, it should assure itself of the following:

- That there is a clear written policy on related-party transactions;
- That there are sufficient systems and internal controls in place to signal these transactions to the board.

■ **Tip 3:** The board should maintain a compliance schedule

Boards should maintain a compliance schedule that shows when various financial, legal, and regulatory requirements must be completed and who is responsible for dealing with each item. Such a schedule is likely to include the following:

- Obligations relating to the preparation and filing of financial statements;
- Tax compliance;
- Banking facilities and covenants;
- Health and safety compliance; and
- Insurance.

■ **Tip 4:** The board should maintain an ethics code

A key responsibility of the board is to promote—and exemplify—high standards of professional and ethical conduct among employees. As the number of employees expands, the expected standards should be summarized in a code of business conduct, which should be discussed with employees during induction and training periods. The code also serves as a benchmark for evaluation during disciplinary proceedings. The board should regularly use staff surveys to check the extent to which the code is being applied throughout the business. For example, when employees reveal in a survey that they have not been trained in the code or that their line manager habitually fails to comply with the code, it is clear that the code is not embedded, and remediation may be required. The internal code could state the company's expectations concerning the following (ecoDa 2010):

- Compliance with laws and regulations;
- Standards of customer service;
- Conflicts of interest;
- Health and safety;
- Gifts or preferential treatment with regard to suppliers, customers, and so on;
- The need for integrity and ethical business practice;
- Company obligations to the general well-being of the community; and
- Support for employee personal development.

5.12. Summary

A large variety of board structures, compositions, and practices exist among companies in Europe. In recent years, board diversity has become an important corporate governance issue, and in particular many European countries have introduced gender quotas. Directors' duties in many countries have been clarified, and there is an increased scrutiny concerning related-party transactions. Board evaluations are becoming increasingly common.

5.13. Resources for this chapter

Books, articles, and surveys:

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Organizations:

BUSINESSEUROPE, www.businessseurope.eu, is a confederation of European businesses that represents more than 20 million small, medium, and large companies. BUSINESSEUROPE members are 40 national industrial and employers federations from 34 countries working together to achieve growth and competitiveness in Europe.

European Confederation of Directors' Associations, www.ecoda.org. ecoDa is a not-for-profit association founded in December 2004 under the laws of Belgium. Its objective is to represent the views of company directors from EU member states to corporate governance policymakers at the EU level. (Its membership is listed in Appendix F.)

European Institute for Gender Equality, www.eige.europa.eu. EIGE is a European agency responsible for collecting and analyzing comparable data on gender issues; developing methodological tools, especially to help integrate gender equality in all policy areas; facilitating the sharing of best practice and dialogue among stakeholders; and raising public awareness.

EuropeanIssuers, www.europeanissuers.eu, is a not-for-profit membership association based in Brussels and representing the interests of quoted companies across Europe. Its aim is to persuade policymakers to create a favorable EU regulatory environment for financial markets that serves the needs of their end users, which are companies and investors. According to EuropeanIssuers, the success of the EU regulatory environment should be judged on whether companies can deliver growth in shareholder value over the longer term, can raise capital through public markets, and can grow to create jobs for individuals, while stakeholders are informed and protected.

European Round Table of Industrialists, www.ert.be. ERT is an influential interest group in the EU comprising 45 European industrial leaders working to strengthen competitiveness in Europe. Overall, the contribution of ERT member companies to the GDP of the EU exceeds that of 21 of the 27 member states.

Federation of European Employers, www.fedee.com. The FedEE, established in 1989 with EU funding, is now an independent organization serving the needs of multinational employers by providing human resources advice focused on employment law, pay, and labor relations.

Global Reporting Initiative, www.globalreporting.org. The GRI develops and disseminates global Sustainable Reporting Guidelines. Its website is a source of information, reports, and guidance on corporate responsibility reporting.

Institute for Family Business, www.ifb.org.uk. The IFB has published a series of guides for family business owners that set out how to identify and tackle the issues they commonly face. It covers the following family business challenges: understanding family business; planning succession; engaging the next generation; professionalizing the board; fostering entrepreneurship; selling the family business; and managing differences.

International Integrated Reporting Council, www.theiir.org. The mission of the IIRC is to enable integrated reporting to be embedded into mainstream business practice in the public and private sectors.

The Management

This chapter discusses the importance and function of management in European companies. It explores issues associated with the dominant CEO, remuneration, and the importance of succession planning.

6.1. The dominant CEO

Management has the greatest capacity to determine the success or failure of a company. Although managers are not the company's key decision makers, they are responsible for running the company on a day-to-day basis. In that role, they need to be granted executive power to exercise discretion over the operation of the company. A key aspect of the governance framework is to establish an appropriate level of executive power to delegate to management. If too little power is granted by the shareholders and the board—and a manager's freedom of action is excessively constrained—the company is likely to become inflexible. Management may be unable to implement the board's strategy.

However, with too much power, the risk exists that management will lose touch with the interests of the board and shareholders and pursue its own agenda. An aggressive CEO can dominate the direction of the company, which can sometimes lead to great success. But it can also lead to failure. With a dominant CEO, the difference between success and failure can depend on whether there is a strong board to counterbalance the CEO (Amble 2011).

6.2. Remuneration

Remuneration of senior management increasingly requires shareholder approval at a general meeting on the policy and various components of compensation of executives. The European Commission's recommendation on remuneration of directors in listed companies (European Commission 2004) introduced the concept of say on pay

into the European Union corporate governance agenda. The Shareholder Rights Directive (European Commission 2014a) improves transparency on remuneration policies and individual remuneration of directors, as well as granting shareholders the right to vote on remuneration policy and the remuneration report. As part of a broader agenda to encourage shareholder engagement in their investee companies, the EU Commission has published proposals concerning say on pay relating to a revised Shareholder Rights Directive (European Commission 2014b).

According to the Commission, companies should benefit from remuneration policies that stimulate longer-term value creation, and executive pay should be linked to performance. Poor remuneration policies and/or incentive structures lead to unjustified transfers of value from companies, their shareholders, and other stakeholders to executives. The Commission's goal is to enhance transparency on remuneration policies and individual remuneration of directors by granting shareholders the mandatory right to vote on remuneration policy and the remuneration report.

A recent study (Barontini et al. 2013) shows that the implementation of EU recommendations concerning remuneration governance and disclosure improved remuneration practices during 2007–2010. Compliance with all applicable criteria has improved across all jurisdictions. Germany, France, and Italy have shown the biggest improvements, and the United Kingdom has the highest level of overall conformity. The survey revealed that remuneration committees are commonly found in most countries and that disclosure of remuneration has improved. It

is affected by firm size, industry, ownership concentration, and country. Variable remuneration of CEOs is important, amounting to 60 percent of total compensation and affected by firm size, growth opportunities, and past firm performance. Board and CEO remuneration decreased after the global financial crisis.

6.3. Succession

Top management succession is another important issue that should be addressed by the governance framework. The business succession and continuity of SMEs in particular is important. When the owner of a business dies or becomes incapacitated, if there is no succession planning it often becomes necessary to shut down an otherwise healthy business. Or in many instances, successors inherit a healthy business, which is forced into bankruptcy because of lack of available liquidity to pay inheritance taxes and other taxes.

Proper planning helps avoid many of the problems associated with succession and transfer of ownership. In recent years, organizations have changed their approach to succession planning from a formal, confidential process of handpicking executives to be company successors to that of a more fluid, transparent practice that identifies high-potential leaders and incorporates development programs preparing them for top executive positions.

6.4. Performance and internal efficiency

The EU Accounts Modernisation Directive (Trucost 2005) requires listed companies to publish an “enhanced directors’ report” in their annual report. Under this directive, the company must provide a balanced and comprehensive analysis of the development and performance of the business of the company during the financial year and the position of the company at the end of that year, consistent with the size and complexity of the business. The regulations state that the review must include analysis using financial key performance indicators (KPIs) and, where appropriate, analysis using other KPIs, including information relating to environmental matters and employee matters. Midsize companies, while not required to include analysis using nonfinancial KPIs, were encouraged to report on these issues voluntarily in recognition of the benefits such disclosure brings to the operation of the business.

Key performance indicators are “factors by reference to which the development, performance, or position of the business of the company can be measured effectively” (Trucost 2005). The selection and number of key performance indicators included in the review is for directors to

decide. The regulations do not say how many KPIs should be included, nor do they mandate any particular KPIs for companies to report on.

In 2013, the coverage of the key performance indicators was extended. European listed companies are also required to disclose in the management report of the company’s annual report relevant and material information on policies, outcomes and risks, and relevant nonfinancial KPIs concerning environmental aspects, social and employee-related matters, respect for human rights, anticorruption and bribery issues, and diversity on the boards of directors (European Union 2013).

6.5. Strategy

Corporate Governance Guidance and Principles for Unlisted Companies (ecoDa 2010) contends that many of the codes in Europe recognize that the level of complexity and strategy of a company will vary according to the stage of development of its board and company (such as start-up, board formation, initial placement offering and listing, international/cross-border activities).

The board should fulfil certain key functions, including: Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

—(OECD 2004)

A company will generally develop a new governance structure and approach in anticipation of its next major strategic move or phase in development or financing structure (for example, before succession takes place in a family firm, before attracting external capital, and so on). Such a change in governance will indicate its readiness to take the next step in its evolution. Events in the company’s lifecycle that may trigger a change in governance approach to strategy include the following:

- *Changes in the relationship between shareholders, the board, and management.* This may be triggered by the desire of the founder entrepreneur or family owners to withdraw from the day-to-day management of the company and hand over executive responsibilities to professional managers. A special

trigger of governance change may be the decision to nominate the first independent non-executive director on the board.

- *Expansion of the shareholder base by attracting additional internal (family, group) shareholders.* This may trigger important challenges for the sole owner (for example, the founder).
- *Change in the capital and shareholding structure, due to a desire to attract external financing.* This will involve dilution in the ownership concentration of existing owners and the entry of external shareholders into the company ownership.
- *Increasing complexity in the company's business portfolio, its business environment, and its risk profile.*

In addition, effective governance requires that the board's and executive team's roles in strategy be clearly defined and established with well-understood boundaries. In practice, these boundaries can vary significantly. For instance, in certain unitary boards the board may play an active role in formulating strategy with the management team at strategy retreats and away days. In other cases, particularly with two-tier boards the supervisory board may have little or no part in formulating the corporate strategy.

6.6. Risk management and internal controls

Effective governance requires that the board's and executive team's roles in risk management be clearly defined and established with well-understood boundaries. As of 2013, European listed companies are required to disclose in the management report of the company's annual report relevant and material information on policies, outcomes, and risks (European Union 2013).

Risk management should be a feature of all businesses. Companies take risks to generate returns. The board is responsible for ensuring that all business risks are identified, evaluated, and suitably managed. In a world of increasing complexity and uncertainty, directors must manage risk more assiduously than ever before. The execution of the risk-management system should be entrusted to the management, which is in charge of daily risk management.

Enterprise risk management is a structured, consistent, and continuous process across the entire company (usually large companies) for identifying, assessing, responding to, and reporting on opportunities and threats that affect the achievement of the company's objectives.

The board should fulfil certain key functions, including: Ensuring the integrity of the company's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards —(OECD 2004)

The amount of risk varies not only with the type of business or its market circumstances but also with the business's stage in its lifecycle. Young, high-growth businesses will be more vulnerable than mature, stable businesses. Acting on management's advice, directors must determine "risk appetite"—how much risk the company can accept. Risk appetite may vary over time and will be influenced by the company's financial condition and market position. As a result of the global financial crisis, since 2008 the focus of many of the corporate governance initiatives has been to prevent excessive risk taking, especially when it involves putting the long-term viability of a company at risk for short-term rewards.

All organizations should be clear about their willingness to accept risk in pursuit of their strategies. Armed with this clarity, boards of directors and management should make informed decisions about what actions to take and what they must do to deal with the associated risks. They can also articulate to owners and stakeholders their approach to risk. Good risk management and internal control are both necessary for the long-term success of all organizations, and internal audit is the last line of defense. Deficiencies in risk management point directly to deficient board oversight.

6.7. External auditors

The recently approved EU Audit Directive and Regulation (see Box 6.1 on page 65) introduced a number of new requirements (European Commission 2014c):

- *Mandatory audit firm rotation.* The legislation introduces mandatory firm rotation for the statutory auditor of a public-interest entity (PIE)⁶ after a maximum initial engagement period of 10 years, although EU member states can require an initial engagement

⁶Article 2(13), Directive 2006/43/EC defines public-interest entities as all entities that are both governed by the law of a member state and listed on a regulated market; all credit institutions in the EU, whether listed or not; all insurance undertakings in the EU, regardless of whether they are listed and regardless of whether they are life, nonlife, insurance, or reinsurance undertakings; or entities designated by member states as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size, or number of employees.

Box 6.1: EU Audit Directive and Regulation

The new legislation goes into effect on June 17, 2016, except for the mandatory firm rotation (MFR) requirements for auditors. MFRs are subject to transition arrangements.

The legislation comprises two legislative instruments: the directive applies to all entities required to have a statutory audit, and the regulation introduces further requirements for public-interest entities.

The legislation includes introduction of 10-year mandatory firm rotation for all PIEs in the EU, subject to member state options to shorten or extend the period and the transitional arrangements relating to length of tenure; far-reaching prohibitions on the provision of non-audit services to audit clients, applicable from June 17, 2016; and a cap of 70 percent on permitted non-audit services, applicable to services provided by the auditor or auditing firm.

Source: ecoDa.

period that is shorter than 10 years (provided it is more than one year). The regulations allow PIEs in member states to extend the initial engagement period by a further 10 years where an audit tender has taken place or 14 years where there is a joint audit. The EU permitted these variations to allow member states such as Italy and the Netherlands to maintain their existing rotation requirements of nine years and eight years, respectively, and France to keep its joint-audit regime.

The effect of these variations may be to create complex and different audit firm rotation periods across the EU, which will be costly for companies and will create confusion and inefficiencies within the EU audit market. This is likely to be particularly problematic in the banking and insurance sectors, where every subsidiary in the EU will have to rotate its statutory auditors in line with its national law, because these subsidiaries will be PIEs in their own right.

The mandatory firm rotation requirements are to be phased in depending on the length of the existing audit relationship on the date the legislation enters into force, such as the following:

- Where the existing audit relationship is 20 years or more in July 2014, the company cannot reappoint its incumbent auditor after July 2020 (that is, six years later).
- Where the existing audit relationship is between 11 and 20 years in July 2014, the company cannot reappoint its incumbent auditor after July 2023 (that is, nine years later).
- Where the existing audit relationship is less than 11 years when the legislation enters into force, the transition period is still uncertain.

- **Significant restrictions on non-audit services.** The legislation also introduced significant new restrictions on the non-audit services a public-interest entity can obtain from its auditor, including the following:
 - Specific tax, consultancy, and advisory services;
 - Services that involve playing any part in the management or decision making of the PIE; and
 - Services linked to the financing, capital structure and allocation, and investment strategy of the PIE.
- **A cap on permitted non-audit services.** The legislation imposes a cap on fees for permitted non-audit services at 70 percent of the statutory audit fee. The cap will be calculated as 70 percent of the average statutory audit fees for the previous three years. The cap will be calculated not only for the audited entity but also at the group level if the audited entity is part of a group of companies. Audit committees will also be required to approve all permissible non-audit services.
- **A report from the auditor to the audit committee.** The legislation also introduces a new report from the auditor to the audit committee. This will cover a variety of information, including the following:
 - A declaration of the auditor's independence;
 - The names of all key audit partners;
 - A description of the scope and timing of the audit work;
 - The overall approach to the audit and any substantial variations, as compared to the prior year;
 - A disclosure of materiality, explaining judgments about events or conditions that may cast significant doubt on the entity's ability to continue as

a going concern, and whether they constitute a material uncertainty; and

- Addressing significant deficiencies in internal financial controls and matters related to actual or suspected noncompliance with laws and regulations.

6.8. Tips

■ Tip 1: Corporate governance statements

Directive 2006/43 requires that a corporate governance statement shall be included as a specific section of the annual report and shall contain at least a reference to the following:

- The corporate governance code the company is subject to, and/or
- The corporate governance code the company may have voluntarily decided to apply, and/or
- All relevant information about the corporate governance practices applied beyond the requirements under national law.

■ Tip 2: A schedule of powers delegated to management

An indicator of good governance is the publication of a schedule of powers delegated to management. This schedule is likely to cover the following areas (ecoDa 2010):

- Preparing strategic proposals, corporate plans, and budgets;
- Executing the strategy agreed on by the board of directors;
- Executing actions in relation to board decisions on investments, mergers and acquisitions, and so on;
- Opening bank accounts and authorizing financial payments;
- Signing contracts;
- Signing regulatory documents;
- Powers of attorney;
- External communication;
- Staff recruitment and remuneration;
- Establishing a system of internal control and risk management; and
- Health and safety operations.

■ Tip 3: Risk register

A risk register should be reviewed by the board on a regular basis. It should contain the following categories of information:

- A description of the main risks facing the company;
- The impact, should this event actually occur;
- The probability of its occurrence;
- A summary of the planned response, should the event occur;
- A summary of risk mitigation (the actions that can be taken in advance to reduce the probability and/or impact of the event).

■ Tip 4: Chief risk officer

In many of the European countries, banks and other financial institutions are required to appoint a chief risk officer. Also, many organizations outside of the financial sector are following this trend and appointing a chief risk officer.

■ Tip 5: Policies

Has your board developed a company manual that is available to all employees, and that outlines policies and procedures relating to the specific risks the company is exposed to? For example, have policies been developed with regard to the following:

- Anti-fraud;
- Anti-corruption;
- Anti-money-laundering;
- Cash management;
- Monitoring of banking covenants;
- Business continuity;
- Data security and reliability;
- Records management;
- Regulatory compliance; and
- Health and safety compliance.

■ Tip 6: Internal control procedures

Has your board developed procedures that support an effective internal control environment? Such procedures are likely to include the following:

- Authorization limits;
- Segregation of duties;
- Accounting reconciliations and monitoring of cash flow;
- Suitable qualifications and training;
- Budgetary controls;

- Controls over funds, expenditure, and access to bank accounts; and
- Security of premises and control over assets.

6.9. Summary

Europe has a wide variety of regulatory constraints on executive management. Different governance challenges and specific codes have been developed to identify best-practice principles for each situation and context.

6.10. Resources for this chapter

Standards:

- ecoDa. 2010. *Corporate Governance Guidance and Principles for Unlisted Companies in Europe*.

Books, articles, and surveys:

Amble, B. 2011. "Dealing with a dominant CEO."

Management-issues.com. Website (February 1). <http://www.management-issues.com/news/6135/dealing-with-a-dominant-ceo/>.

Barontini, R., S. Bozzi, G. Ferrarini, and M. Ungureanu. 2013. "Directors' remuneration before and after the crisis: Measuring the impact of reforms in Europe." In *Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms*. M. Belcredi and G. Ferrarini, eds. Cambridge: Cambridge University Press.

ecoDa. 2010. *Corporate Governance Guidance and Principles for Unlisted Companies*. Brussels: The European Confederation of Directors' Associations.

European Commission. 2004. "Recommendation on remuneration of directors in listed companies (2004/913/EC)." Working Document. Brussels: European Commission. www.ec.europa.eu.

European Commission. 2014a. "Directive of the European Parliament and of the Council: Amending Directive 2007/36/EC." Proposal. Brussels: European Commission.

European Commission. 2014b. "European Commission proposes to strengthen shareholder engagement and introduce a 'say on pay' for Europe's largest companies." Press Release (April 9). Brussels: European Commission. www.ec.europa.eu.

European Commission. 2014c. "EU Audit Directive and Regulation." Factsheet. Brussels: European Commission. www.ec.europa.eu.

European Union. 2013. "Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements. . . amending Directive 2006/43/EC. . . and repealing Council Directives 78/660/EEC and 83/349/EEC." *Official Journal of the European Communities* (June 29). Luxembourg: European Union.

Noked, N. 2014. "Board refreshment and director succession in investee companies." Blog Post. *Harvard Law School Forum on Corporate Governance and Financial Regulation* (September 6).

OECD. 2004. *Principles of Corporate Governance*. Paris: Organisation for Economic Co-operation and Development.

Pierce, C. 2010. *Corporate Governance in the European Union*. London: Global Governance Services Ltd.

Trucost. 2005. "EU Accounts Modernisation Directive." *Trucost Guide* (November 28). London: Trucost plc.

Organizations:

Institute of Risk Management, www.theirm.org. IRM is a leading risk education institute.

Federation of European Risk Management Associations, www.ferma.eu. FERMA provides the means of coordinating risk management and optimizing the impact of National Risk Management Associations outside of their national boundaries on a European level.

The Institute of Internal Auditors, www.theiia.org. IIA is an international professional association of more than 170,000 members.

International Federation of Accountants, www.ifac.org. IFAC is the global organization for the accountancy profession. It includes over 175 members and associates in 130 countries and jurisdictions, representing approximately 2.5 million accountants in public practice, education, government service, industry, and commerce.

European Accounting Association, www.eaa-online.org. EAA aims to link the Europe-wide community of accounting scholars and researchers, to provide a platform for the wider dissemination of European accounting research, and to foster and improve research to ensure the development and the promotion of accounting as well as the improvement of teaching skills.

Global Association of Risk Professionals, www.garp.org. A not-for-profit organization, GARP is the only globally recognized membership association for risk managers. Its goal is to help create a culture of risk

awareness within organizations, from entry level to board level.

International Accounting Standards Board, www.ifs.org, is the independent standard-setting body of the International Financial Reporting Standards (IFRS) Foundation.

Fédération des Experts-comptables Européens (Federation of European Accountants) www.fee.be. FEE is an international non-profit organization based in Brussels. It represents 47 institutes of professional accountants and auditors from 36 European countries, including all of the 28 EU member states.

Stakeholders, Corporate Responsibility, and Ethics

The role of company stakeholders—such as employees, financiers, suppliers, local communities, and government—varies considerably across companies, sectors, and countries. This chapter looks at this role in the context of corporate responsibility and the ethical behavior of organizations.

7.1. Stakeholders

In some European countries, the rights of stakeholders are enshrined in company law or other related legislation, such as codetermination and employment-protection legislation. In Germany, for example, a 1976 law mandated that worker representatives hold seats on the boards of all companies employing over 500 people. Proponents of codetermination argue that it leads to reductions in management-labor conflict by means of improving and systematizing communication channels.

By contrast, companies in other countries have a tradition of focusing more narrowly on the interests of shareholders. However, regardless of legal obligations, the governance framework should take into account the interests of stakeholders. The risks to the company of insufficiently incorporating the stakeholder perspective into governance arrangements could be considerable. Consequently, well-governed companies in Europe make an effort to establish and maintain dialogue and constructive engagement with relevant stakeholders.

7.2. Corporate social responsibility

In 2001, there was no appetite in Europe for legislation in the area of corporate social responsibility (CSR). The European Commission published a green paper on the subject, recommending that the member states take a voluntary approach to the issue (European Commission 2001). (Also, see Section 6.4. “Performance and internal efficiency,” on page 63, for a discussion of the EU Accounts Modernisation Directive and KPIs.)

The European Commission tend to focus upon corporate social responsibility (CSR) and has defined CSR as “the responsibility of enterprises for their impact on society.” —(European Commission 2011)

In 2006, the Commission launched the European Alliance for CSR as a forum to develop CSR initiatives by companies and their stakeholders. And in 2011, the Commission published a CSR Strategy for the EU (European Commission 2011) that defined CSR as the “responsibility of enterprises for their impacts upon society.” The Commission’s CSR agenda for action involves the following:

- Enhancing the visibility of CSR and disseminating good practices;
- Improving and tracking levels of trust in business;
- Improving self- and co-regulation processes;
- Enhancing market reward for CSR;
- Improving company disclosure of social and environmental information;
- Further integrating CSR into education, training, and research;
- Emphasizing the importance of national and subnational CSR policies; and
- Better aligning European and global approaches to CSR.

In 2014, the Commission initiated a consultation on the

CSR strategy for the EU. A 2014 Grant Thornton study of some 2,500 companies identified the key corporate responsibility drivers, as shown in Table 7.1.

In Europe, private sector companies are being encouraged in their corporate responsibility (CR) approaches by investors, consumers, the public sector, and governments. In some cases, governments have formalized a number of corporate responsibility requirements in legislation and regulations. In other cases, CR activities and approaches are encouraged through voluntary measures, and corporate responsibility remains a nonmandatory corporate activity, without compulsion or persuasion. In all cases, corporate responsibility involves wider contact with company stakeholders.

SustainAbility corporate responsibility studies

A study of corporate responsibility issues by SustainAbility, IFC, and Ethos Institute confirmed that economic and ethical considerations are key drivers of corporate responsibility, although the business case varies by region and company size (SustainAbility, IFC, and Ethos 2002).

For example, the study reports that SMEs emphasize cost savings in their CSR activities, but they also achieve higher revenues and improved market access through environmental products and services. Although national companies and multinational corporations based in emerging markets gain primarily through cost savings from environmental process improvement, they also benefit in all other categories. CSR also benefits foreign multinationals that are headquartered

Corporate Responsibility is a term that is used by some member states and can be defined as “the voluntary action businesses take over and above legal requirements to manage and enhance economic, environmental and societal impacts.” —(UK Department for Business, Innovation and Skills 2014)

in developed countries and have operations in emerging markets; they often experience such intangible benefits as risk reduction and human-capital development.

The SustainAbility study goes on to say that export-oriented companies that adhere to sustainability standards and management systems have better access to markets and can sometimes apply price premiums to their products. The study also reports, “Companies focused on the domestic market are more likely to gain from local economic and community development, which strengthens their license to operate and can deliver revenue growth.”

An ethical culture in a company is typically associated with the following:

- Enhanced corporate reputation and image;
- Improved risk management;
- Improved disaster recovery and business continuity;
- Stronger stakeholder relationships; and

Table 7.1: Top 10 Corporate Responsibility Drivers

	Activity	% of Companies
1	Cost management	67
2	Customer demand	64
3	The “right thing to do”	62
4	Brand building	59
5	Staff recruitment/retention	58
6	Tax relief	42
7	Government pressure	39
8	Saving the planet	38
9	Investor relations	38
10	Public pressure	30

Source: Grant Thornton 2014.

- Possible improvement in avoiding or mitigating litigation.

7.3. The business case for corporate responsibility

For many businesses, corporate responsibility provides the critical link between responsible practice and market advantages. Generally, boards consider the company's short-term and long-term interests when developing strategic, corporate, or business plans, and directors usually envision planning horizons of three to five years, although longer time periods are possible.

Boards nearly always recognize that, at least in the longer term, if the company does not look after its customers, sales are likely to suffer; if it is regarded as a bad employer, it will be harder to recruit good people; if it fails to pay its debts, credit will be more costly and difficult to get; and so on. Corporate reputation is a valuable asset and is seen to be so. Naturally, short-term pressures sometimes prevail, particularly in times of hardship or crisis, but if they persistently prevail, the company will cease to exist. The following are key business practices for a company that intends to thrive:

- **Manage risks to earn/maintain a license to operate.** A company's long-term viability depends on continued support for its activities from the wider community and stakeholders, including customers, employees, shareholders, and/or government. Companies must identify and analyze their stakeholders to determine which ones may threaten or prevent their operations.
- **Enhance corporate reputation and brand image.** Business success is highly dependent on the company's reputation within the community.
- **Reduce or eliminate avoidable risks and losses** (such as those related to damage to reputation or operations or related to changing community attitudes) through corporate responsibility initiatives.
- **Improve access to markets and customers,** because the company is learning from, innovating with, and responding to changes within society. Corporate responsibility supports a climate that encourages a company to identify and take advantage of business opportunities, to develop new business practices, and to maintain or enhance competitiveness.
- **Increase employee motivation, retention, and productivity.** A company's reputation affects its desirability as a potential workplace. It is in a company's strategic interests to attract and retain the most highly skilled and expert employees, and

this can be encouraged by maintaining an ethical and attractive reputation. Generally, quality CR approaches reduce employee absenteeism and turnover.

- **Enhance relations with communities and regulators.** The long-run viability of a business depends on its strategic positioning, which includes developing the economy and community where it operates, working with government to facilitate better regulatory regimes, or integrating environmental breakthroughs into assets to reduce lifecycle costs and improve efficiency.
- **Improve relations with shareholders and other stakeholders.** Investment capital is important for a company's ongoing activities and its ability to expand or enter into new ventures. Technology advancements have ensured that investors have greater access to information about a company's operations, including its social and environmental performance. There is evidence that investors are increasingly taking these factors into account when making investment decisions.

Directors have an important role in articulating and embedding an appropriate culture. Many corporate failures in the EU are associated with flawed culture. Therefore, effective boards should seriously consider such metrics as customer complaints, whistleblowing incidents, disciplinary cases involving infringements of the company's code of conduct, and so on. The internal audit function can play an important role in this effort.

7.4. Ethical and responsibility frameworks used in Europe

The following concepts, publications, and initiatives cover a range of ethical and responsible practices that together form CR frameworks for European companies:

- **The triple bottom line (1994).** Corporate responsibility has developed out of a focus on the "triple bottom line" elements of a business and their effects on the economy, the environment, and the society in which it operates. CR is inextricably entwined with corporate governance, strategy, and risk. In 1994, John Elkington used and established the phrase "triple bottom line" to describe what he saw as the ever-increasing trend for organizations to demonstrate transparency and accountability in areas beyond financial reporting and performance.

Elkington considers the triple bottom line as a way of focusing companies' business decisions "not just on the economic value they add, but also on the envi-

ronmental and social value they add—or destroy” (Elkington 1999). Many companies, including multinationals, began their commitment to corporate responsibility and sustainable development through consideration of the triple bottom line.

- **United Nations Global Compact (2000).** Originally launched in 2000, the Global Compact is a voluntary corporate citizenship initiative. It “provides a framework for businesses that are committed to aligning their operations and strategies with ten universally accepted principles in the areas of human rights, labour, the environment and anti-corruption.” To support and assist businesses that aspire to responsible conduct, it provides tools, templates, and other mechanisms to ensure business engagement in the areas of its 10 principles. (See Box 7.1.)

The old methods of reporting are proving to be no longer sufficient. New forms of corporate disclosure which integrate financial, environmental and social reporting are starting to take shape. Triple bottom-line reporting is a path which points to practical benefits for companies themselves as well as their varied stakeholders. —John Elkington

- **UN Principles for Responsible Investment (2006).** The United Nations-supported Principles for Responsible Investment (PRI) Initiative is an international network of investors working together to put the six

Box 7.1: The UN Global Compact—10 Principles

The Global Compact’s 10 principles are derived from The Universal Declaration of Human Rights; The International Labour Organization’s Declaration on Fundamental Principles and Rights at Work; The Rio Declaration on Environment and Development; and The United Nations Convention Against Corruption.

The Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labour standards, the environment, and anti-corruption:

HUMAN RIGHTS

- Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and
- Principle 2: make sure that they are not complicit in human rights abuses.

LABOUR STANDARDS

- Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
- Principle 4: the elimination of all forms of forced and compulsory labour;
- Principle 5: the effective abolition of child labour; and
- Principle 6: the elimination of discrimination in respect of employment and occupation.

ENVIRONMENT

- Principle 7: Businesses should support a precautionary approach to environmental challenges;
- Principle 8: undertake initiatives to promote greater environmental responsibility; and
- Principle 9: encourage the development and diffusion of environmentally friendly technologies.

ANTI-CORRUPTION

- Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.

Source: UN 2002.

[B]usiness is too often linked with serious dilemmas—for example, exploitative practices, corruption, income equality, and barriers that discourage innovation and entrepreneurship. Responsible business practices can in many ways build trust and social capital, contributing to broad-based development and sustainable markets. —(UN 2002)

Principles for Responsible Investment into practice. (See Box 7.2.) Its goal is to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision-making and ownership practices. The principles are designed to be compatible with the investment styles of large, diversified, institutional investors that operate within a traditional fiduciary framework. In early 2014, the Principles had been endorsed by 1,250 institutional investors (UNPRI).

- **OECD Guidelines for Multinational Enterprises (2011).** In 1976, the OECD developed guidance for multinational enterprises (MNEs) on appropriate business conduct, which it reviewed in 2000 and 2011. The OECD Guidelines for MNEs provide voluntary principles and standards for responsible business conduct in a variety of areas, including employment and industrial relations, human rights,

environment, information disclosure, combating bribery, consumer interests, science and technology, competition, and taxation.

The MNE Guidelines are the only multilaterally endorsed guidance on global business conduct and aim to promote economic, environmental, and social progress. While the MNE Guidelines are nonbinding for enterprises, they are influential, because governments have committed to them and to promoting both their observance and their effective implementation. The guidelines are listed in Box 7.3 on page 74.

- **Global Reporting Initiative (G4 Guidelines, June 2013).** The GRI developed the Sustainability Reporting Guidelines based on the assumption that a company has determined its commitment to a corporate responsibility program and will report on its progress to its stakeholders. The guidelines support stakeholder engagement in sustainability discussions, the presentation of sustainability reports, and benchmarking. The guidelines provide 1) reporting principles, 2) standard disclosures, and 3) an implementation manual. The GRI framework offers indicators that stakeholders may use to assess the company's performance as a responsible corporate citizen. (See Table 7.2 on page 75.)
- **Equator Principles (2013).** The Equator Principles were originally devised by a group of major financial institutions in June 2003 under the auspices of IFC. In June 2013, IFC released a newly revised set of principles. The Equator Principles provide

Box 7.2: UN Principles for Responsible Investment

The Principles for Responsible Investment are voluntary and aspirational. They offer a menu of possible actions for incorporating environmental, social, and corporate governance (ESG) issues into investment practices across asset classes.

- Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
- Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
- Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
- Principle 6: We will each report on our activities and progress towards implementing the Principles.

Source: UNPRI 2006.

Box 7.3: OECD Guidelines for Multinational Enterprises

The Guidelines for Multinational Enterprises state that enterprises should take fully into account established policies in the countries in which they operate, and consider the views of other stakeholders. The following are what the guidelines say enterprises should do:

1. Contribute to economic, environmental and social progress with a view to achieving sustainable development.
2. Respect the internationally recognised human rights of those affected by their activities.
3. Encourage local capacity building through close co-operation with the local community, including business interests, as well as developing the enterprise's activities in domestic and foreign markets, consistent with the need for sound commercial practice.
4. Encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees.
5. Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to human rights, environmental, health, safety, labour, taxation, financial incentives, or other issues.
6. Support and uphold good corporate governance principles and develop and apply good corporate governance practices, including throughout enterprise groups.
7. Develop and apply effective self-regulatory practices and management systems that foster a relationship of confidence and mutual trust between enterprises and the societies in which they operate.
8. Promote awareness of and compliance by workers employed by multinational enterprises with respect to company policies through appropriate dissemination of these policies, including through training programmes.
9. Refrain from discriminatory or disciplinary action against workers who make bona fide reports to management or, as appropriate, to the competent public authorities, on practices that contravene the law, the Guidelines or the enterprise's policies.
10. Carry out risk-based due diligence, for example by incorporating it into their enterprise risk management systems, to identify, prevent and mitigate actual and potential adverse impacts and account for how these impacts are addressed. The nature and extent of due diligence depend on the circumstances of a particular situation.
11. Avoid causing or contributing to adverse impacts on matters covered by the Guidelines, through their own activities, and address such impacts when they occur.
12. Seek to prevent or mitigate an adverse impact where they have not contributed to that impact, when the impact is nevertheless directly linked to their operations, products or services by a business relationship. This is not intended to shift responsibility from the entity causing an adverse impact to the enterprise with which it has a business relationship.
13. In addition to addressing adverse impacts in relation to matters covered by the Guidelines, encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of responsible business conduct compatible with the Guidelines.
14. Engage with relevant stakeholders in order to provide meaningful opportunities for their views to be taken into account in relation to planning and decision making for projects or other activities that may significantly impact local communities.
15. Abstain from any improper involvement in local political activities.

Source: OECD 2011.

Table 7.2: GRI Categories

Category	Subcategory	Aspects
Economic		Economic Performance Market Presence Indirect Economic Impacts Procurement Practices
Environmental		Materials Energy Water Biodiversity Emissions Effluents and Waste Products and Services Compliance Transport Overall Supplier Environmental Assessment Environmental Grievance Mechanisms
Social	Labor Practices and Decent Work	Employment Labor/Management Relations Occupational Health and Safety Training and Education Diversity and Equal Opportunity Equal Remuneration for Women and Men Supplier Assessment for Labor Practices Labor Practices Grievance Mechanisms
	Human Rights	Investment Nondiscrimination Freedom of Association and Collective Bargaining Child Labor Forced or Compulsory Labor Security Practices Indigenous Rights Assessment Supplier Human Rights Assessment Human Rights Grievance Mechanisms
	Society	Local Communities Anti-corruption Public Policy Anti-competitive Behavior Compliance Supplier Assessment for Impacts on Society Grievance Mechanisms for Impacts on Society
	Product Responsibility	Customer Health and Safety Product and Service Labeling Marketing Communications Customer Privacy Compliance

Source: GRI 2013.

a financial industry benchmark for determining, assessing, and managing environmental and social risks in projects. As of 2014, 80 Equator Principles Financial Institutions (EPFIs) in 34 countries have officially adopted the Equator Principles, covering over 70 percent of international project finance debt in emerging markets. Box 7.4 lists the 10 topic areas.

- **Sustainability Code, Germany (2014).** The Sustainability Code was developed in Germany by the German Council for Sustainable Development (RNE) and German businesses, investors, and civil society. It is available in its revised form in English, French, and German (RNE 2014). It comprises 20 criteria and follows on from existing voluntary reporting standards. Introduction of the GRI's guidelines in 2013 triggered a review and update of the Sustainability Code. The code criteria is in line with the definition of the forthcoming EU directive on the disclosure of nonfinancial and diversity information.

The Sustainability Code has stimulated other countries to develop sustainability standards. For example, the Greek QualityNet Foundation is planning to offer a sustainability index on the Athens stock exchange and to help Greek businesses become more competitive by virtue of the “Sustainable Greece 2020” strategy.

- **Directive on disclosure of non-financial and diversity information (2014).** In September 2014, the Council of the European Union adopted the Directive on disclosure of nonfinancial and diversity information by large companies and groups. It amends the Accounting Directive (2013/34/EU) and applies to large public interest entities with more than 500 employees. Public interest entities include listed companies as well as some unlisted companies, such as banks, insurance companies, and other companies that are so designated by member states because of their activities, size, or number of employees. These companies are required to disclose information on the following in their annual reports:

- Environmental;
- Social and employee matters;
- Respect for human rights;
- Anti-corruption and bribery matters.

The disclosure needs to include a description of the following:

- The policy pursued by the company related to these matters;
- The results of these policies;
- The risks related to these matters; and
- How the company manages those risks.

Box 7.4: Equator Principles

The following are the topic areas covered by the Equator Principles:

- Principle 1: Review and Categorisation
- Principle 2: Environmental and Social Assessment
- Principle 3: Applicable Environmental and Social Standards
- Principle 4: Environmental and Social Management System and Equator Principles Action Plan
- Principle 5: Stakeholder Engagement
- Principle 6: Grievance Mechanism
- Principle 7: Independent Review
- Principle 8: Covenants
- Principle 9: Independent Monitoring and Reporting
- Principle 10: Reporting and Transparency

Source: EP 2013.

7.5. Corporate responsibility trends

Companies and their boards of directors worldwide have been giving increasing attention to corporate responsibility and even formalizing, through policies and reports, CR-related activities, reporting, and communication. Table 7.3 shows companies' involvement in corporate responsibility activities, according to a 2014 study (Grant Thornton 2014).

Corporate responsibility equities indexes

Stock exchanges developed equity indexes to measure companies' performance relative to CR areas, especially to economic, environmental, social, and other criteria and standards. Such indexes are multiplying and spreading the influence of CR activities and reporting. In 2001 in the United Kingdom, for example, the London Stock Exchange launched the FTSE 4 Good Index, "which measures the performance of companies that meet environmental and social standards."⁷

Socially responsible investment

Socially responsible investment (sometimes also referred to as "green" or ethical investing) involves investment

strategies that seek to combine both financial return and social good. The Eurosif (2012) survey found that European responsible investment strategies outgrew the market and that in four out of six cases have grown by more than 35 percent annually since 2009.

Ethical Investment Research Service corporate responsibility studies

An Ethical Investment Research Service study (EIRIS 2007) concluded that, in the past 25 years, corporate responsibility "has evolved from a mainly philanthropic activity to a more mainstream approach that integrates responsible business principles into core business activities." The EIRIS study found that European companies have well-developed responsible business practices across a broad range of issues.

Another EIRIS study (EIRIS 2009) examined environmental issues (including climate change and biodiversity), social issues (including human rights, labor practices in the supply chain, and health and safety), and governance issues (including board practices and bribery). The surveyed companies scored much better in environmental areas than in social or governance areas.

Table 7.3: Companies' Involvement in Corporate Responsibility Activities

	Activity	% of Companies
1	Donated money to community causes/charities	68
2	Participated in community/charity activities	65
3	Improved energy efficiency/waste management	65
4	Donated products/services to a charitable organization	53
5	Changed products/services to reduce their environmental impact	39
6	Calculated carbon footprint	31
7	Partnered with a charitable organization	30
8	Intentionally sourced local, ethical trade, or organic products	26
9	Changed products/services to reduce their social impact	25
10	Participated in CSR platforms/initiatives	25
11	Conducted due diligence on impact of business on human rights	24
12	Partnered with a charitable organization to address business issues	20

Source: Grant Thornton 2014.

⁷ See London Stock Exchange: www.londonstockexchange.com.

Nearly 75% of European companies that operate in high risk countries have developed a basic or advanced human rights policy compared with less than 40% of North American companies and around a sixth of Asian companies. . . . European and Japanese companies are clear leaders with respect to managing environmental impacts. Over 90% of high impact companies in Europe and Japan have developed basic or advanced policies, compared with 75% in Australia/ New Zealand, 67% in the US and 15% in Asia, ex-Japan. —(EIRIS 2007)

7.6. Obstacles to corporate responsibility

Any company introducing corporate responsibility concepts and practices into its organization may find the journey difficult. Below are some issues such a company might face:

- **Conflicting approaches.** Several conflicting approaches to corporate responsibility are being promoted in the marketplace, and that may lead to confusion and inertia. In trying to select the “most appropriate way,” a company may have to invest time and money in understanding the various approaches and tools, such as the following (many of which are described in sections 7.2 and 7.3, above):
 - UN Global Compact
 - UNEP Finance Initiative
 - Equator Principles
 - EMS/ISO 14000
 - Global Reporting Initiative
 - Enhanced Business Reporting Initiative
 - Institutional investors’ specific requirements
 - Indexes (FTSE 4 Good)
 - Media: “most admired companies” lists, and so on
 - Activists: militant, ethical, e-advocates
- **A mixed level of understanding of the benefits and importance of corporate responsibility.** Insufficient research has been done to date to validate its effectiveness and to demonstrate its benefits for a business and society.
- **Uneven commitment throughout the company.** As a company introduces CR activities, it may take

a top-down approach. Those at the top level may understand corporate responsibility and be committed to it, but the rest of the organization may not. There is often a need for capacity building and empowerment of employees, particularly to avoid conflicting messages within a company regarding corporate responsibility. For example, the employees operating with suppliers in a profit-led economic model will need to understand the procurement impacts of a CR policy or philosophy. Relationships with suppliers will change, and vendors will need to be able to ensure quality throughout supply chains. Some supply chains are complex, and it will be difficult to ensure dissemination of corporate responsibility messages and accompanying process.

- **Barrier to entry.** For a growing company, the need to identify and fulfill CR requirements may be a barrier to entry. For example, CR requirements may be stipulated as part of a listing process and may delay the application process. The costs of CR implementation related to possible internal audits, external assurance, CR reporting, information gathering, and CR monitoring may serve as additional barriers.
- **Practical barriers to the application of corporate responsibility best practices.** At a very basic level, most CR guidelines and support materials are available in English. Translations into other major languages are only starting to appear. Therefore, information accessibility is an issue in some environments. Also, a company may need to resolve conflicting stakeholder expectations and priorities regarding corporate responsibility activities. Further, a CR team may be charged with change and yet be hampered by being separate from the rest of the entity it is expected to bring change to.

These obstacles may be overcome in several ways, such as through board commitment, a comprehensive company education and capacity-building program, and communication and engagement programs with stakeholders. But such solutions do not result in changes overnight. Therefore, many companies commence CR activities in a low-key manner and build goals and activities over time.

7.7. Board role in corporate responsibility

The board of directors has a responsibility to act in good faith, with due care and diligence, in the best interests of the company and its shareholders. For the company to

fulfill its corporate responsibilities, the board should set a clear vision and key strategies for the company and monitor management to ensure that quality risk controls and risk-management practices are in place.

Companies are expected to abide by all laws applicable to them. However, a board may determine the extent to which a company will undertake additional voluntary CR measures. Further, given the board's prime responsibility to the company's best interests, it will undertake CR activities that are aligned with the company's strategies and key interests. The board's role in CR is evolving but still largely defined by its general responsibilities. The board's specific roles may include the following:

- The board can provide inspiration and leadership for CR projects.
- The board, together with the senior management, should set the strategic direction for the entity, including ensuring that the CR strategy reflects the company's values and core business.
- Directors should ensure that appropriate structures are in place for successful CR. This might mean establishing a committee at the board level to oversee CR activities, as the global pharmaceutical company Pfizer did, or giving an existing board committee—most often the audit committee, which oversees audit and risk policy and activities—the task of overseeing CR within the company. The relevant group may monitor any conflicts that arise between company goals—short-term and long-term—and CR strategies. But note that all risk, including the risk that arises out of the company's approach to CR issues, remains a matter for the whole board.
- The board has the capacity to ensure a coherent approach to CR within the company by locating a “home” and accountability for CR activities. Some companies appoint a corporate responsibility or ethics officer to promote appropriate conduct within the company. Others require the corporate counsel to monitor CR strategy and activities.
- A board has the capacity to make a commitment to the global CR trend by establishing corporate codes of conduct and policy guidelines in relevant areas.
- Directors can guide management in communication of the company's corporate responsibility stance, internally and externally.
- The board is accountable to shareholders for information that is provided—financial and nonfinancial.

The board, or its delegated committee, will oversee the integrity of information communicated to shareholders and stakeholders regarding CR. Increasingly, it is good practice to have the corporate responsibility information publicly available and assured, often by an independent third party.

7.8. Ethics

According to findings by Casson (2013), many companies in Europe recognize that business ethics, sustainability, and social responsibility, as well as boardroom ethics, characterize a well-run business and are essential to long-term success. In today's environment, stakeholders have high expectations that companies will be run in accordance with good corporate governance practices. Many European companies recognize that, to encourage positive behaviors and repeat business with their customers, they need to undertake their business in the right way. Thus they draw up their values and instill them in their employees—and monitor to be sure they do business accordingly, knowing that they will be held accountable if they do not. The values espoused, for example, include integrity, honesty, and openness. (See Box 7.5 on page 80.)

Questions of ethics, or the right way to do business, are inherent in all aspects of corporate governance and in every board decision and action. A business problem typically involves ethics when issues are not covered by law or the boundaries of right and wrong are not clear. Several factors have led boards around the world to take a greater interest in ethics:

- **Corporate misgovernance.** Examples abound! For instance, Morgan Stanley estimates that the reporting scandals involving LIBOR (the London Interbank Borrowing Offered Rate) and EuBOR (the European Borrowing Offered Rate) have led to a cost of \$22 billion. In another example, JPMorgan Chase had a \$5.8 billion trading loss in the first quarter of 2012 because of a rogue trader known as “the London Whale.”
- **Whistleblowing.** A whistleblower exposes misconduct or alleged dishonest or illegal activity occurring in an organization. The alleged misconduct may be, for example, a violation of a law, rule, or regulation; or it could be a direct threat to public interest, such as fraud, health and safety violations, and corruption. Whistleblowers may make their allegations internally (to others within the accused organization) or externally (to regulators, law enforcement agencies, the media, or groups concerned with the

particular issues). Increasingly, professionals in this area are using the term “speak up” rather than “whistleblowing,” because it encourages people to raise an issue before any harm is actually done, whereas whistleblowing comes after the event.

- **Increased focus on ethics by investors and other stakeholders.** Many companies over the last decade have placed more attention on ethics and corporate social responsibility as a result of pressure from investors and stakeholders.

- **Increased transparency.** Corporate reporting disclosure has substantially increased over the last 10 years. Also, increased Internet access to this disclosed information has allowed outsiders to decide what they like or dislike about a particular organization.

We close with the results of a study on ethics and integrity, by the Institute of Business Ethics (Box 7.6), and a guide on director integrity, by GUBERNA, the Belgian Directors Association (Box 7.7 on page 81).

Box 7.5: A Study of Ethics Codes in the United Kingdom

A 2003 study of U. K. companies by the Institute of Business Ethics (Webley and More 2003) made the following discoveries:

- Companies with an ethics code outperformed those without one—in economic value added, market value added, and price-to-earnings (P/E) ratio.
- Companies with an ethics code experienced far less P/E volatility than did those without one.

In 2007, the IBE repeated the study (Ugoji, Dando, and Moir 2007) and found that the companies that provided training in business ethics and financial performance fared better than did those that merely disclosed ethical values and provided no training.

Source: Institute of Business Ethics.

Box 7.6: Ethical Issues Associated with Company Behavior (United Kingdom)

In 2013, the Institute of Business Ethics identified the top 15 ethical issues associated with company behavior in the United Kingdom. They are as follows:

1. Corporate tax avoidance
2. Executive pay
3. Employees being able to speak out about company wrongdoing
4. Bribery and corruption
5. Discrimination
6. Environmental responsibility
7. Harassment and bullying in the workplace
8. Sweatshop labour
9. Fair and open pricing of products and services
10. Human rights
11. Advertising and marketing practices
12. Openness with information
13. Safety and security in the workplace
14. Work-home balance for employees
15. Treatment of suppliers

Source: IBE 2013.

Box 7.7: Director Integrity

GUBERNA, the Belgian Directors Association, produced a detailed guide on what it means for a director to behave with integrity:

1. A director **acts ethically and with integrity** (base of minimum requirements for moral values) in accordance with the applicable governance codes and company practices. A director is able to describe the behaviour and identify the common values of the company (for example, respect, dialogue, tolerance, diversity or pluralism).
2. A director has the personal and professional qualities that meet the highest definition and most demanding standards in terms of **integrity, honesty and loyalty**.
 - A director organises his or her personal and professional life so that it does not interfere with or hinder the exercise of his or her professional functions.
 - A director maintains under all circumstances his or her independence of analysis, decision-making and action and rejects any form of pressure.
3. The **integrity** of a director includes—at the very least—respect for both the letter and intention of written and unwritten rules and customs in place within the company.
4. **A director is familiar with, follows and complies** with the procedures put in place within the company to avoid and/or resolve conflicts of interest. When relevant, a director will notify and inform the other directors of his or her interests, clearly and *in tempore non suspecto*. To this end, the director will contact the designated persons within the company.
5. A director participates in the development and promotion of a **culture of honesty**. Honesty consists of irreproachable behaviour, with regard to both the laws and the company's internal rules, as well as the generally accepted definition of honesty (uprightness, loyalty, etc.).
 - A director does not participate in any way in unlawful transactions and does not use unlawful means to perform his or her duties.
 - A director draws a clear line between the performance of his or her official duties for the company and the promotion of other professional or business activities or executive responsibilities. A director does not use his or her office or the information obtained further thereto for purposes other than to manage and represent the company.
 - A director does not participate in the creation of misleading situations and does not spread or state incorrect information.
6. **A director is incorruptible**. A director takes care to maintain his or her free will and to ensure that he or she is free of all pressure when taking decisions.
7. **A director is loyal**. A director is faithful to his or her commitments. Such loyalty is constant and should be displayed prior to taking up the directorship, during the appointment process and performance of the directorship, and after the end of the director's term of office.
8. **A director is trustworthy**. He or she is capable of safely maintaining the confidence of information received. A director acts in a courteous manner and maintains relations characterised by good faith, in order to preserve the confidence and trust required by his or her office.
9. **A director is responsible**.
 - A director acts with diligence and efficiency. He or she behaves and takes decisions in a responsible manner. A director displays caution and reserve in the exercise of his or her duties.
 - A director refrains from holding indiscrete or indelicate conversations about any information that is brought to his or her attention both during and outside the performance of his or her duties.
 - A director respects his or her commitments and assumes the consequences of his or her behaviour (acts and/or omissions). A director discharges the duties conferred on him or her, in pursuit of the company's objectives, to the best of his or her abilities and with discernment.
 - A director is in general true to his or her commitments.

Source: GUBERNA 2012.

7.9. Tips

- **Tip 1: Local corporate responsibility issues**
Well-governed companies in Europe research and recognize company and local corporate responsibility issues.
- **Tip 2: Stakeholder engagement**
Well-governed companies in Europe define the relevant CR issues by engaging stakeholders, listening to shareholders, and assessing the business impact.
- **Tip 3: Business case for CSR**
Companies normally make a business case for corporate responsibility after undertaking a SWOT (strengths, weaknesses, opportunities, and threats) analysis.
- **Tip 4: Action plan**
The action plan should commit to action and then formalize that commitment by establishing a CR policy. Here the board will demonstrate leadership.
- **Tip 5: Integration**
Boards need to integrate strategies and ensure alignment with company strategy by considering the company supply chains, company risks, and strategies for quality.
- **Tip 6: Building awareness**
Boards need to build awareness for corporate responsibility and engage stakeholders.
- **Tip 7: Corporate responsibility**
Boards need to define and refine areas of CR for action and implementation.
- **Tip 8: Review**
Boards need to review the available tools to assist implementation; choose and apply the corporate responsibility tool most appropriate for the company at that time; ensure that there is adequate board leadership, management structure, and capacity to support CR; and establish continuous-improvement review mechanisms for CR.
- **Tip 9: Communication**
Boards need to convey the message about CR strategies and performance throughout the company as well as to shareholders and stakeholders.
- **Tip 10: Measurement and reporting mechanisms**
Boards need to establish CR measurement and reporting mechanisms to demonstrate transparency; and they need to look ahead, monitor for improvements, and build trust.

7.10. Summary

This chapter examined the different ethical contexts for and approaches to corporate social responsibility that operate in Europe.

7.11. Resources for this chapter

Standards:

The International Corporate Governance Network offers the following standards:

- Statement and Guidance on Anti-Corruption Practices (2009); and
- Statement and Guidance on Political Lobbying and Donations (2012).

Books, articles, and surveys:

- Baskin, J., and K. Gordon. 2005. "Corporate responsibility practices of emerging market companies." A Fact-Finding Study. OECD Working Paper on International Investment 2005/03. Paris: Organisation for Economic Co-operation and Development.
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- Organizations:**
- Accountability*, www.accountability.org.uk, is a professional institute promoting social and ethical accountability. It provides ratings, strategies, tools, and connections related to corporate responsibility.
- Caux Round Table*, www.CauxRoundTable.org. This United States-based organization disseminates information on ethical business practices and moral capitalism.
- CSR Europe*, www.csreurope.org, is a European business network reference point for socially responsible issues. Its website has case studies, publications, and activities related to corporate responsibility.
- German Council for Sustainable Development*, www.deutscher-nachhaltigkeitskodex.de, published the Sustainability Code in 2014. The code and a manual for using the code in midsize companies can be ordered free of charge from the Council.
- Global Reporting Initiative*, www.globalreporting.org. The GRI develops and disseminates global Sustainable Reporting Guidelines. Its website is a source of information, reports, and guidance on corporate responsibility reporting.
- Institute of Business Ethics*, www.ibe.org. This London-based institute disseminates information on ethical business practices.
- UN Global Compact*, www.unglobalcompact.org, is a voluntary framework for businesses committed to aligning their strategies and operations with principles on corporate citizenship. Its website provides guidelines and recommendations on corporate responsibility.
- Whistleblowers UK*, www.whistleblowersuk.org, is the first group in the United Kingdom set up by whistleblowers and their supporters to provide advice and support to those who are considering acting on conscience. Established in December 2012 at City University, London, it provides a network of support, legal advice, and other services to whistleblowers.
- SustainAbility*, www.sustainability.org, is a think tank and strategic advisory firm working to catalyze business leadership on sustainability.

Appendixes

Appendix A: Countries of the Eurozone

Appendix B: Member States of the EU

Appendix C: EU Candidate Countries

Appendix D: Potential Candidate Countries

Appendix E: Council of Europe Member States

Appendix F: Members of ecoDa

Appendix G: Control-Enhancing Methods in Europe

Appendix A: Countries of the Eurozone

The 18 countries of the Eurozone, followed by date of membership:

Austria (1999)	Finland (1999)	Ireland (1999)	Malta (2008)	Slovenia (2007)
Belgium (1999)	France (1999)	Italy (1999)	Netherlands (1999)	Spain (1999)
Cyprus (2008)	Germany (1999)	Latvia (2014)	Portugal (1999)	
Estonia (2011)	Greece (2001)	Luxembourg (1999)	Slovak Republic (2009)	

Appendix B: Member States of the EU

The 28 current member states of the EU, followed by date of membership:

Austria (1995)	Estonia (2004)	Italy (1952)	Portugal (1986)
Belgium (1952)	Finland (1995)	Latvia (2004)	Romania (2007)
Bulgaria (2007)	France (1952)	Lithuania (2004)	Slovak Republic (2004)
Croatia (2013)	Germany (1952)	Luxembourg (1952)	Slovenia (2004)
Cyprus (2004)	Greece (1981)	Malta (2004)	Spain (1986)
Czech Republic (2004)	Hungary (2004)	Netherlands (1952)	Sweden (1995)
Denmark (1973)	Ireland (1973)	Poland (2004)	United Kingdom (1973)

Appendix C: EU Candidate Countries

The five current EU candidate countries:

Iceland	Serbia	Macedonia, FYR	Turkey	Montenegro
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Appendix D: Potential Candidate Countries

The three countries that are currently potential candidate countries:^a

Albania; Bosnia and Herzegovina; Kosovo

^a This designation is without prejudice to positions on status, and it is in line with UNSCR 1244/99 and the ICJ Opinion on the Kosovo declaration of independence.

Appendix E: Council of Europe Member States

The 47 Council of Europe member states:

Albania	Estonia	Lithuania	Russian Federation
Andorra	Finland	Luxembourg	San Marino
Armenia	France	Macedonia, FYR	Serbia
Austria	Georgia	Malta	Slovak Republic
Azerbaijan	Germany	Republic of Moldova	Slovenia
Belgium	Greece	Monaco	Spain
Bosnia and Herzegovina	Hungary	Montenegro	Sweden
Bulgaria	Iceland	Netherlands	Switzerland
Croatia	Ireland	Norway	Turkey
Cyprus	Italy	Poland	Ukraine
Czech Republic	Latvia	Portugal	United Kingdom
Denmark	Liechtenstein	Romania	

Appendix F: Members of ecoDa

IoD (United Kingdom), GUBERNA (Belgium), IFA (France), ILA (Luxembourg), IC-A (Spain), Hallitusammattilaiset ry (Finland), the Slovenian Association of Supervisory Board Members (Slovenia), the Croatian Association of Certified Supervisory Board Members (Croatia), the Polski Instytut

Dyrektorów (Poland), Styre Institutt (Norway), Styrelse Akademien (Sweden), Vereinigung der Aufsichtsräte in Deutschland (Germany), NedCommunity (Italy), the Danish Board Network (Denmark), and the Macedonian Institute of Directors (FYR Macedonia).

Appendix G: Control-Enhancing Methods in Europe

A control-enhancing mechanism (CEM) allows block holders to enhance control by leveraging voting power. There are 13 CEMs in Europe:⁸

Multiple voting rights shares:

Some shares issued by a company can give different voting rights based on an investment of equal value. Many European companies (particularly Sweden and the Netherlands) issue voting shares with different voting power. For example, some types of shares might give one vote per unit of par value, and other types of shares might give 10 votes per unit of par value. The reason the concept of multiple voting rights exists is to “protect the great thinking of grandfather.” It may also be a response to the assumptions that 1) shareholders think in the short term while the company and its stakeholders think in the long term; and 2) shareholders do not understand the business model or that protection is needed from a hostile takeover.

Non-voting shares (without preference):

Some shares have no voting rights and carry no special cash-flow rights (such as a preferential dividend) to compensate for the absence of voting rights. These are common in the United Kingdom and France.

Non-voting preference shares:

These are non-voting shares issued with special cash-flow rights to compensate for the absence of voting rights and are prevalent in Italy, Germany, and the United Kingdom. For example, shares might have no voting rights but have a preferential (higher or guaranteed) dividend.

Pyramid structures:

Pyramid situations occur when a company controls another corporation that in turn holds a controlling stake in another corporation, which can be repeated a number of times. The higher the number of companies involved in the pyramid, the higher the degree of deviation from the proportionality between ownership and control.

Priority shares:

These shares grant their holders specific powers of decision or veto rights in a company, irrespective of the proportion of their equity stake. They are commonly found in the Netherlands, the United Kingdom, and France. The rights attributed to the holders of priority shares vary from company to company and can include

the entitlement to propose specific candidates to the board of directors or the right to directly appoint board members, or they may involve veto powers of decisions taken at the general meeting.

Depository certificates:

These are financial instruments representing the underlying shares in a company that are held by a foundation that administers the voting rights. In this case, the holder of the depository certificates does not hold voting rights, but only the financial rights of the underlying share. The depository certificates are the financial instruments issued on the market and represent the shares held by the foundation, which executes the votes. This instrument is used in particular in the Netherlands.

Voting-right ceilings:

A voting-right ceiling is a restriction prohibiting shareholders from voting above a certain threshold irrespective of the number of voting shares they hold. Voting-right ceilings can be expressed as a percentage of all outstanding voting rights (for example, when no shareholder may vote for more than 3 percent of the company’s registered share capital) or as a percentage of all votes cast at a general meeting. Ceilings are common in many European countries. Related to voting-rights ceilings is the “one head, one vote” rule found in the cooperative banks where there is a limit to the number of shares that can be held by any one shareholder and each member is entitled to a single vote, regardless of the number of shares held.

Ownership ceilings:

An ownership ceiling is an example of share transfer restrictions, which prohibit potential investors from taking participation in a company above a certain threshold (these are common in Italy and the United Kingdom).

Supermajority provisions:

Supermajority provisions exist where company bylaws or the national law require a majority of shareholders larger than 50 percent plus one vote to approve certain important corporate changes.

Partnerships limited by shares:

Partnerships limited by shares are a particular legal corporate structure authorized by some European countries—for example, the French *Sociétés en Commandite par*

⁸ Sherman & Sterling, “Proportionality between ownership and control in EU listed companies: A comparative legal study,” External Study commissioned by the European Commission, 2007.

Actions or the German Kommanditgesellschaft auf Aktien (KGaA). These companies have two different categories of partners (without having two types of shares): the general partners (unlimited liability partners or associés commandités) who run the company, and the limited sleeping partners (limited liability partners or associés commanditaires) who contribute equity capital but whose rights are limited to monitoring rights.

Golden shares:

Golden shares are priority shares issued for the benefit of governmental authorities. Golden shares confer special rights to national or local governments or government-controlled vehicles to maintain control in privatized

companies by granting rights that go beyond those associated with normal shareholding. They can enable governments to block takeovers, limit voting rights, or veto management decisions.

Cross shareholdings:

Cross shareholdings occur when Company X holds a stake in Company Y, which in turn holds a stake in Company X. Circular holdings, where A has shares in B, B in C, and C in A, are a special case of cross shareholdings.

Shareholders agreements:

These agreements can be formal or informal shareholder alliances.

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