

# The Board's Role in Designing an Effective Framework for Corporate Governance

ecoDa and Mazars Roundtable



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On 18 June 2018, the European Confederation of Directors Associations (ecoDa) and Mazars organised a roundtable in Brussels centered around their recent report on. *“The board's role in designing an effective framework of corporate governance”*

With this report, ecoDa and Mazars have delved into the practices of European listed companies in designing the necessary corporate governance structures, disclosing corporate governance practices, as well as the application of the ‘comply or explain’ (CoE) principle, and the overall impact of corporate governance codes and recommendations on business.

This survey follows a *first report issued in 2015* which provided an overview of the monitoring systems across the EU Member States and highlighted the multitude of monitoring approaches, as well as the ambiguity associated when interpreting the CoE principle (this can range from strictly self-regulatory set-ups with very permissive views on non-compliance, to wholly or partly legal-based approaches with strong expectations of compliance).

The roundtable gathered an array of experts— from business representatives and regulators, to proxy advisors and institutional investors— for a broad discussion about the role of shareholders, proxy advisors, boards, and regulators in supporting sustainable success in corporate governance.

The event was co-chaired by Anthony Carey, Head of Board Practice at Mazars, and Michel de Fabiani, Chairman of the Policy Committee at the European Confederation of Directors Associations (ecoDa).



# Is there a consistent legislative approach to corporate governance?

Overall, the EU legislation welcomed the CoE approach, as illustrated by the 2014/95 EU Directive on the disclosure of non-financial statements, the 2017/828 EU Directive on the encouragement of long-term shareholder engagement, and the 2012/0299 EC Proposal for a Directive on gender diversity.

However, as underlined by Michel de Fabiani, there are duplication concerns between regulation and codes. Given that the nature of corporate governance codes are often based on a performance or behavioral approach, this creates rather frequent updates of codes. But, as highlighted by Jo Iwasaki, Head of Corporate Governance at the ACCA, this is not the only explanation. According to her, other major reasons for frequent updates of codes can also be attributed to constant development of best practices, and the need to align codes with the changes in regulation. In any case, without a degree of stability, this can erode trust in corporate governance codes altogether.

When revisions to corporate governance codes do take place, a more principles-based approach is often favored, much like in the UK where preference for strict compliance is not common practice. The EU on the other hand—becoming more harmonized in their approach—is bringing together hard law (e.g. on gender, remuneration, sensitive societal issues) with a soft law approach (a much more principles-based approach), such as codes and guidelines.

This EU approach could be a possible solution to avoid running the risk of ossifying corporate governance codes within mandatory regulatory frameworks. Bringing together hard and soft law can allow for consistency while providing a framework with expandable boundaries. An “only” hard law approach can limit flexibility margins, and restrain innovation in the development of new codes. This flexibility is needed to ensure that the “bar” is continuously being set at a higher level than the fixed “threshold” defined by law and other mandatory regulation.



# Are proxy advisors open to Comply or Explain (CoE)?

As illustrated in the ecoDa/Mazars joint survey, in many instances, proxy investors act on behalf of individuals holding a significant proportion of total shares in certain companies (investors). This often raises accountability questions on the influence of proxy advisors on corporate governance decisions, and their responsibilities when compared to those of dominant shareholders with similar voting powers. Given their important role, the roundtable explored whether proxy agencies— assessing the corporate governance of invested companies for shareholders— have a preference for companies to ‘comply’ rather than ‘explain’ regardless of the circumstances.

Proxy advisor at Glass Lewis, Patrick Fiorani shared his practical insights on the CoE principle from a client perspective, particularly on the implementation of recommendations coming from proxy advisors. Mr. Fiorani pointed out that their clients turn out to be their own judges. If proxy advisors accept an explanation, that does not necessarily mean that their clients will follow suit. Because clients can verify the information, recommendations from proxy advisors do not carry as much weight as is generally understood.

However Proxy advisors do appreciate tailor-made explanations, specific to the company, clarifying why it is not suitable for them to apply the corporate governance codes or an alternative solution. With such explanations, proxy advisors must also take into account that with the variety of best practices in Europe, what might seem acceptable in the case of some companies is not always acceptable in the case of others. When such realities are appropriately considered, he found that— in most cases— proxy advisors are open to an explanation.

Also, it would be seem that explanations provided by companies related to independence issues are better accepted by proxy advisors. Such explanations are easier to check by just simply verifying the overall board composition and, based on that, determining where there might be some concerns.

Whatever their degree of openness, today we see more proxy advisors revising their codes of practice, while investors are becoming subjected to greater stewardship codes inspired from CoE. This approach is key to ensuring flexibility and agility for both advisors and investors in meeting the needs of invested companies.

# Does providing an explanation always reflect good corporate governance?

As a corporate respondent to the ecoDa/Mazars survey pointed out: “Proxy agents tend to ignore the ‘Comply or Explain’ flexibility, and vote ‘no’ on principle if there is non-compliance.” While general opinion suggests that proxy advisors are followed blindly by their clients, Mr. Fiorani has not found this to be the case. From his experience, whilst the saying “comply or you get a recommendation against” is in everyday practice, this is simply not the case in reality. Glass Lewis is keen to consider explanations that go beyond “boiler plate” language, and, in most cases, such explanations are accepted. Mr. Fiorani also underlined Glass Lewis’ eagerness to engage with issuers to better understand deviations from best practice recommendations on a case by case basis. At a minimum, the company’s explanation is included in the Proxy Report to allow its readers to make up their own minds.

Among the experts present, Ms. Iwasaki expressed concerns about the practices of proxy advisors, particularly when writing their reports. In her view, what proxy advisors produce is influenced by topics and agendas perceived as popular among the investor community, and this in turn has an impact on investors’ behaviors (i.e. the market), thereby creating closed and potentially narrow perspectives.

With respect to such concerns, Mr. Fiorani explained that proxy advisors predominantly base their guidelines on corporate governance codes, with very few cases of deviation based on common market practices, not considered as codes. These recommendations are then backed up by the recommendation of national investor associations. Contrary to the dominant idea, he insists that proxy advisors do not push the market in their direction. Changes in the law or governance codes are the main drivers of changes in their guidance of proxy advisors. It might be fairer to say, instead, that investors themselves are freer to take an activist stance in comparison to proxy advisors. The latter are expected to justify their recommendations to clients, and increasingly to issuers, especially when it goes against a widely accepted best practice code.

Additionally, according to Robbert Gerritsen, Vice-President of the Institutional Shareholder Services, proxy advisors should be seen as market followers and not activists. They review their policy each year and look for feedback from the market to adapt their benchmarks. They develop different standards and base their work on market consensus. However, it is true that by publishing their policies, proxy advisors could influence, to a certain extent, the development of standards.

When we consider the issue from the user side, particularly in cases where proxy advisors communicate explanations to their clients, the ecoDa/Mazars joint survey brings to light that such explanations are met with little challenge from investors. With little to no investigation on the explanations or recommendations provided by proxy advisors, the degree of engagement from institutional investors is put into question, as their approach to their governance responsibilities is increasingly understood to be more reactive than pro-active.

# How far can we go by just talking about remuneration?

Moving beyond the proxy advisor's role, the roundtable turned its attention to the nature of discussions with investors, highlighting that the latter seems to focus their attention primarily on remuneration and the nomination of directors.

Experts pointed out that the major reason investors focus on remuneration lies in the disclosure, the quantification and the tangibility of the information, which contributes to an evidence-based approach to corporate governance. Such tangibility is all the more appreciated since there is no concrete evidence proving that corporate governance codes contribute to bettering the performance of companies. As announced in the Shareholders Rights Directive, the European Commission is now in the process of developing non-binding standards for remuneration reports. It will be interesting to see, as announced in the Shareholders Rights Directive, how the European Commission will develop non-binding standards for remuneration reports, and the impact it will have on improving comparability.

However, going beyond remuneration, it could be argued that corporate governance and sustainable business performance would be likely to improve in overall terms if investors took a greater interest in a broader range of issues such as purpose, corporate culture, strategy, risk management and succession-planning. And for Peter Swabey, Policy and Research Director at ICSA, company secretaries want to speak strategy with investors, not just remuneration.

## What can we learn from institutional investors?

Elaborating on the topic of ownership engagement, Mats Isaksson, Head of the Corporate Affairs Division at the OECD, presented observations from discussions with institutional investors on the basis of the OECD report called *"Institutional investors as owners: who are they and what do they do?"* (2013).

The report argues that ownership engagement among institutional investors is based on many factors related to the composition of their business models, which can vary based on the purpose of the institution, its liability structure and its portfolio strategy. According to Mr. Isaksson, rather than addressing institutional investors as a homogenous group, he suggests focusing on the specific features of the relevant institutions' business model to identify incentives for ownership engagement as a means to understand and/or better influence investors. Since incentives differ widely among investors, stewardship codes have little chance to become a boilerplate solution to investors' engagement.

There may also be a need to reflect further on the actual business models of stock exchanges, the increased use of indexing, and the need for long-term stable shareholders.

# Pressed for time, how to get companies, investors and proxy advisors talking?

Though most of the roundtable experts agreed that investor engagement varies from one market to another, some systemic challenges were nevertheless identified.

Among the main hurdles cited, Aleksandra Palinska, Senior Policy Adviser at EuropeanIssuers, criticised some institutional investors who refuse to make their identities known to companies in their portfolios. Consequently, this hampers any dialogue companies would like to pursue with their investors. Ms. Palinska underlined EuropeanIssuers long-term engagement in promoting shareholder identification— i.e. the right for companies to know their shareholders. Additionally, in cases where investors blame their weak engagement on time constraints, she supports the idea of suspending their voting rights, as it unilaterally undermines the companies' willingness to foster dialogue.

Dr. Cordula Heldt, Head of Corporate Governance and Company Law at Deutsches Aktieninstitut, adds that from an economic perspective, for multi-investors with multiple stakes, it might be more rational not to vote. Such investors, most often pressed for time, often rely on their proxy advisors to express their rights, resulting in decisions that may not be taken in the interest of the company. This is why, according to Dr. Heldt, regulatory pressure should not be put on shareholders to make decisions for the company, but instead legislators and regulators should rely on the supervisory board when it comes to oversight and strategic decisions. This approach has been promoted in the EU Shareholder Rights Directive, allowing for a Member State option— in the case of party transactions— to hand over the approval of such transactions to the supervisory board or a committee rather than to the shareholders.

Coming back briefly to the role of proxy advisors in the dialogue, Ms. Palinska highlighted their difficult positioning, particularly when their recommendations are not necessarily in line with their clients initial voting intentions. This often contributes to misunderstandings with the companies as investors change course in exercising their vote.

The need for greater dialogue between companies, investors and proxy advisors to ensure better understanding and alignment is key according to Ms. Palinska. However, even for proxy advisors, time is of the essence during the so-called “proxy season”, when proxies are expected to liaise with companies on a daily basis as they attend and present their reports at Assembly General Meetings (AGMs). Taking this constraint into account, Ms. Palinska expressed EuropeanIssuers commitment in encouraging their members to engage with proxy advisors outside the proxy season.

On the subject of engagement, Mr. Fiorani highlighted Glass Lewis' engagement efforts, and stressed that while they have been proactively seeking dialogue with issuers, they also welcome meeting requests initiated by issuers themselves.

# Is corporate governance going through a life crisis?

The ecoDa/Mazars survey highlights that good corporate governance codes can drive company reputation and sustainable success. However, the roundtable questioned whether such a view is shared across-the-board.

According to Ms. Iwasaki, when something goes wrong with companies without a specific cause being identified, revising the corporate governance code often becomes an attractive idea to many.

Experts at the roundtable also underlined how codes, at times, can serve as an obstacle to innovation and value creation within companies. Mr. Isaksson suggested that it sometimes may be more interesting to look at the explanations as to why corporations do not comply with a specific recommendation. These explanations may even reveal constructive and innovative examples on how to structure governance arrangements in an increasingly dynamic world.

Krzysztof Grabowski, Corporate Governance Advisor of the Conference of Financial Companies in Poland and Member of the European Corporate Governance Codes Network, considers that justifying compliance is just as important. In his view, explaining in corporate governance reports how companies comply is insightful for investors, expanding their perception on the value of the company. On the flip side, he also supports explanations for non-compliance, viewing it as higher in value, as it assesses whether a given company's practice is better than the one expected by the code. Bringing the focus on Poland, Mr. Grabowski explained that, indeed, there is a crisis today in corporate governance which manifests itself in the weak consideration given to corporate governance reports. Too much standardization of corporate governance reports will contribute to the demise of corporate governance.

Mr. de Fabiani, on the other hand, took the opportunity to share two key trends that demonstrates greater awareness around issues of corporate governance. This includes the increasing dialogue with investors and proxy advisors, as well as the progressive change in mind-sets, illustrated by the increased diversity in the nominations for board appointments. This diversity is key to ensuring a challenger mentality, conducive to a dynamic board room.



# What is the board's role in promoting long-term and sustainable success tomorrow?

Sustainability and strategy go hand in hand, according to Mr. de Fabiani, and long-term strategy is key. However, because board directors and corporations are expected to manage simultaneously both their strategies and their business, this creates a real issue. With investors and financial analysts tending to focus primarily on financial reports, board members often feel pressured to also focus on financials, thereby privileging the short-term side of strategy.

Elaborating on a practical solution to promote sustainable corporate governance, Pascal Durand-Barthez, lawyer in Paris specialising in corporate governance, advocated reporting obligations on sustainability.

Mr. Barthez's suggestion falls at a timely moment, given the European Commission's recent *Action Plan on Sustainable Finance*. This legislative initiative launched by the European Commission (EC) in March 2018, will significantly impact— in the coming years— not only reporting requirements to shareholders, but also the investment decisions made by institutional investors.

The EC aims to integrate ESG factors (Environment, Social and Governance) into every level of the decision-making process associated with European capital markets. If this initiative proves successful, board members and shareholders will have access to reports with indicators going beyond the balance sheet. New fiduciary duties defined around sustainability will oblige board members to consider a more long-term vision in their business strategies.

However, the question is whether board members will be ready or have the know-how, in due course, in developing the necessary measures to ensure this shift towards a more long-term strategy.

*Mazars and ecoDa would like to thank all the experts listed below for attending the roundtable and contributing their valuable insight.*



**Sara Baldi**  
Senior Policy Adviser at FESE



**Olivier Boutellis-Taft**  
CEO of Accountancy Europe



**Anthony Carey**  
Partner at Mazars



**Michel de Fabiani**  
Chair of ecoDa's Policy Committee



**Philippe de Harlez de Deulin**  
Audit Partner at Mazars



**Annelies De Wilde**  
Senior Research Associate at Guberna  
(Member of ECGCN)



**Pascal Durand-Barthez**  
Member of the Paris Bar



**Patrick Fiorani**  
Research and Engagement, Continental Europe at Glass  
Lewis



**Robbert Gerritsen**  
Vice-President of Institutional Shareholder Services



**Corentin Gobiet**  
Junior Researcher at Guberna



**Krzysztof Grabowski**  
Corporate Governance Advisor  
(Member of ECGCN)



**Cordula Heldt**  
Head of Corporate Governance and  
Company Law at DAI – *By conference call*



**David Herbinet**  
Partner at Mazars



**Mats Isaksson**  
Head of Corporate Governance at OECD



**Jo Iwasaki**  
Head of Corporate Governance at ACCA



**Fatemeh Jailani**  
Head of European Affairs at Mazars



**Martine Klutz**  
Managing Director at BNP Paribas



**Pedro Oliveira**  
Director for Legal Affairs at BusinessEurope



**Aleksandra Palinska**  
Senior Policy Adviser at EuropeanIssuers



**Rudi Plettinx**  
CEO of ABIS



**Béatrice Richez-Baum**  
Director General of ecoDa



**Peter Swabey**  
Policy and Research Director at ICOSA



**Cecilia Thorn**  
Head of International Relations  
at the Financial Reporting Council (FRC)



**Johan Tyteca**  
Secretary to the Board of Directors  
at KBC Group NV

# CONTACT

## **Mazars**

### **David Herbinet**

Partner, Global Head of Audit  
Mazars Group  
[david.herbinet@mazars.co.uk](mailto:david.herbinet@mazars.co.uk)

### **Anthony Carey**

Partner, Head of Board Practice  
Mazars United Kingdom  
[anthony.carey@mazars.co.uk](mailto:anthony.carey@mazars.co.uk)

### **Fatemeh Jailani**

Head of European Affairs  
Mazars Group  
[fatemeh.jailani@mazars.fr](mailto:fatemeh.jailani@mazars.fr)

## **ecoDa**

### **Béatrice Richez-Baum**

Director General  
[beatrice.richez-baum@ecoda.org](mailto:beatrice.richez-baum@ecoda.org)

More information on [www.ecoda.org](http://www.ecoda.org) and [www.mazars.com](http://www.mazars.com)