Dialogue with the European Commission on corporate governance

On 7 June 2012, members of the European Audit Committee Leadership Network (EACLN) met in Brussels. In one session, members discussed current European Union (EU) initiatives on corporate governance with Eric Ducoulombier, acting head of the unit dealing with corporate governance and social responsibility within the Internal Market and Services directorate of the European Commission.

This document summarizes the key points that members raised in the discussion, along with background information and perspectives that members shared before the meeting. For further information about the network, see “About this document,” on page 8. For a list of participants, see Appendix 1 on page 9.

Executive summary

Proposals for changes in corporate governance policy are under review at the EU level. In April 2011, the European Commission published a green paper on corporate governance, and in March 2012, the European Parliament adopted a resolution on corporate governance policy. Now the commission is drafting an initiative in response to the Parliament’s resolution and public comment on the green paper. EACLN members discussed several relevant issues with Mr Ducoulombier:

- **A growth-oriented corporate governance agenda (Page 2):**

  Members support reforms that are clearly linked to an improvement in corporate performance, but said that such reform is a low priority compared with the need for economic growth. Mr Ducoulombier agreed that growth is a top priority for the commission and that any new initiatives must be pro-growth. The commission is developing a road map for action on corporate governance and company law that will extend into 2015. This road map envisions a range of options, from recommending best practices to mandatory directives or regulations. Members encouraged the commission to also consider governance practices in other important entities, such as state-owned enterprises, public agencies and non-profit organizations.

- **Three key corporate governance issues (Page 3):**

  Members and Mr Ducoulombier discussed the separation of the board chair and CEO roles, quotas for women on boards and limits on board mandates. Members broadly agreed that the roles of the board chair and the CEO should be separate. However, they said that the decision should be left up to each board and explained to its shareholders. Some members wanted to be respectful of different national cultures rather than adopt a one-size-fits-all approach. Mr Ducoulombier observed that in the absence of compelling evidence linking role separation to company performance, it might be difficult to justify intervention.

  Members acknowledged the undeniable impact that quotas for women board members have made in certain countries, such as France and Norway, but preferred disclosure of diversity policies for board composition and increasing female board membership on a comply-or-explain basis. Mr Ducoulombier...
noted that the commission is gathering additional data on the connection between female board membership and company performance.

Members and Mr Ducoulombier agreed that limiting the number of board mandates for each public company board director in Europe was unworkable. Directors are accountable for their availability to the board chairman – and ultimately to the shareholders – and this should determine their capacity to serve on multiple boards. Members recommended that before a director takes up a position on any new board, permission should be sought from all the boards on which the director currently serves.

- The comply-or-explain approach (Page 6)

Members and Mr Ducoulombier view the comply-or-explain approach as an important basis for corporate governance reform. However, Mr Ducoulombier called for more effective explanations and suggested national authorities should monitor explanation disclosures more actively.

A growth-oriented corporate governance agenda

On 5 April 2011, the European Commission issued a green paper entitled *The EU Corporate Governance Framework*. Michel Barnier, commissioner for Internal Market and Services, said, “In the current economic situation, we need more than ever to ensure that companies are well governed and consequently reliable and sustainable. Too much short term thinking has had disastrous consequences. That is why we have launched today a debate on the effectiveness of the existing corporate governance framework. Above all, we need company boards to be more effective and shareholders to fully assume their responsibilities.”

On 29 March, 2012, the European Parliament adopted a resolution on a corporate governance framework for European companies, essentially a comment on the commission’s green paper that offers opinions and recommendations concerning the commission’s proposal. While it welcomed the effort to revise the corporate governance framework to create a more transparent and accountable corporate sector, it regretted that the green paper did not address certain issues, such as directors’ responsibility and independence, conflicts of interest and stakeholders’ involvement. It also urged the commission to pay more attention to the dual-board system of corporate governance – used, for example, in Germany and the Netherlands – and to the role of different committees of the board, including the audit committee.

Mr Ducoulombier and network members discussed the commission’s corporate governance initiatives currently under development in response to Parliament’s resolution and the feedback received on the green paper:

- Agreement on growth orientation. Mr Ducoulombier noted that “The link is clear between good governance in financial institutions and the recent financial crisis … There is not the same feeling about non-financial institutions.” Mr Ducoulombier added that, “There is a link between governance and the internal market. It’s a driver to secure a market in which companies and their shareholders and creditors feel comfortable working.” He emphasized that “growth is at the very top of the commission’s political agenda” and that any proposals or initiatives taken by the commission must be considered “growth friendly.”

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3 This approach means that a company choosing to depart from a provision in a corporate governance code has to explain its reasons for doing so.
6 Under a dual board system, a management board directs the company’s operations but is accountable to a supervisory board elected by shareholders.
Members were encouraged by this approach. One member said, “There is a general receptivity to improving corporate governance. Governance is linked to good performance. Through Sarbanes-Oxley and changes in the UK, all companies have changed to become more effective. But more regulation, large and small, is a deterrent to growth.”

- **A road map for action.** Mr Ducoulombier explained that Commissioner Barnier’s intention is to present initiatives on both corporate governance and company law in mid-October 2012. These initiatives would not include draft directives or regulations, but would act as a “road map” or “action plan” for change through to the end of the current commission’s term in 2015. Mr Ducoulombier noted that the commission “will be acting through a wide range of instruments … ranging from doing nothing to regulating with hard law, and including recommendations, codes of conduct, debates and peer pressure.” Mr Ducoulombier also told members that “the jury is out; we have no preconceived ideas. We want to add value, not do things for the sake of doing things.”

- **Public-sector governance issues.** Several members suggested that the commission should expand the scope of governance initiatives to include state-owned enterprises, public agencies and non-profit organizations because of their importance in the European economy. Mr Ducoulombier agreed, noting there must be “good reasons” to justify a difference in governance standards between state-owned and publicly listed companies.

### Three key corporate governance issues

While the green paper and the Parliament’s report address a wide range of corporate governance issues, Mr Ducoulombier and members explored three particularly controversial and significant issues for non-executive directors:

- Separation of board chair and CEO roles
- Quotas for women board members
- Limits on board mandates

#### Separation of board chair and CEO roles

The green paper did not discuss this issue extensively, but simply asked whether the functions and duties of the chair and the CEO should be clearly divided. In its summary of the responses to the green paper, the commission noted, “74% of respondents had a clear view on this question. The outcome was equally divided between respondents supporting and those opposing. Employees, institutional and retail investors, civil society groups, the insurance sector, proxy agents and auditor/accountants were more favourable,” while “companies, business federations, the banking sector and liberal professions tended to be against.”

The Parliament’s resolution stated that “in unitary systems there should be a clear demarcation” but also noted that “this rule should be proportional to the size and the peculiarities of the company.”

- **Members broadly support separation of the board chair and the CEO.** Members agreed in principle that the CEO should not also serve as board chair. One member said, “The separation of the
chair and CEO is best for quality and efficiency.” Another remarked, “The role of the board is to oversee and constructively challenge management. A combined chair/CEO is a conflict of interest.”

Mr Ducoulombier said the commission was “fully neutral on board structures” and observed that “this is almost an issue of religion – very polarizing.” He noted that there was an increasing sense that it is healthier to separate the two roles, but there is little hard evidence linking separation of the roles to improved performance, except for financial institutions, which makes it difficult “to justify regulations” for other public companies.

- **Implementation should be on a comply-or-explain basis.** Members believe that for a variety of reasons, companies may need to approach the general principle of role separation in their own way. One member said, “One size doesn’t fit all. Even in same sector, you need to adapt to public-owned, state-owned enterprises, privately held companies.” Another stated, “Because of the traditions and culture in [my country], a majority of companies are not ready to put in place this principle … A good implementation would be [on the basis of] “comply or explain.” Several members recommended that boards regularly consider the question, especially when a new CEO is appointed. They should then disclose their decision to shareholders. Mr Ducoulombier observed that the fact that the commission had initiated a public discussion about separating the chair and CEO roles has triggered more board discussion and debate at general assemblies.

- **An independent chair may be more important for good governance.** Several members indicated that the board chair role should be both separate from the CEO role and held by an independent director. One member remarked, “An independent chair to challenge management is very powerful. The sense that the chair doesn’t own the past and isn’t defending decisions that led to the company’s uncompetitive position is important.” Another member agreed: “It is crucial to have an independent chair. A lead director is not good enough as they don’t chair the board discussion or decide how much time and how much controversy is on the board’s agenda.”

The criteria for determining whether a non-executive director is independent vary from country to country. One member noted, “We need a better definition of independent, non-executive roles. For example, in Belgium, if you’ve served three terms on the board, you’re not considered independent. In the US, you would still be an independent board director. In the UK, because you are the chair, you may not be independent. Uniformity of definitions would be very helpful.”

**Quotas for women board members**

The commission’s green paper cited studies pointing to the benefits of gender parity on boards and sought input on whether a better gender balance should be required, and if so, how. According to the summary of responses, “The majority of the respondents to this question rejected the idea of listed companies being required to ensure a better gender balance on the boards.”

The Parliament’s resolution took a different tack. Calling for more data on female representation and the measures taken so far by business and member states, the resolution stated that if these steps are found to be inadequate, the commission should “propose legislation – including quotas – in the course of 2012 to

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10 The lead director leads the work and chairs meetings of the independent non-executive board directors.
increase female representation in corporate management bodies to 30% by 2015 and to 40% by 2020, while taking account of the Member States’ responsibilities and of their economic, structural (i.e., relating to company size), legal and regional specificities.”¹²

Gender balance on the supervisory board has become a prominent issue in Europe, and several European countries have already established quotas, including Belgium, France, Italy, the Netherlands and Spain (though the last two have no sanctions for non-compliance).¹³ Meanwhile, a commission consultation focused specifically on gender imbalance in the boardrooms of listed companies ran from 5 March to 28 May 2012. Led by Justice Commissioner Viviane Reding, the commission’s report cited the limited progress on increasing the number of women on boards and asked for input on possible actions at the EU level, including legislation.¹⁴

▪ **Members agreed that quotas have produced results.** Members pointed to significant increases in board diversity in countries where quotas have been imposed. After France adopted a quota in January 2011, the proportion of women on the boards of French companies in the CAC 40 Index increased from 12.3% in October 2010 to 22.3% in January 2012.¹⁵ A member admitted, “I have fought against quotas all of my life, but they have achieved a lot.” Another member mentioned that in France “there are a great number of qualified [female board] candidates in the pool. There are now 600 women [who are] directors or in training to become directors. Quotas are a pity, but they are producing results.” Mr Ducoulombier agreed that “quotas brought about spectacular changes – that is a fact.”

▪ **Members debated whether quotas should be adopted.** One member “did not see evidence of progress without quotas.” Another member suggested that if a company didn’t achieve certain targets in an agreed time frame, “quotas could then be imposed.” Other members suggested that policies for enhancing gender balance should be adopted on a comply-or-explain basis.

Mr Ducoulombier said there was mixed research data linking female board participation to improved company performance. Some studies showed a link, others did not. “There is a feeling,” Mr Ducoulombier said, “that having more women contributes to better control, quality of discussion and better decisions.” The European Commission will continue to gather more data, because the commission “has to act on hard evidence. For the moment, it is difficult to demonstrate a link either way.”

**Limits on number of board mandates**

The commission’s green paper notes the increasing demands on non-executive directors and asks if there should be limits on the number of mandates, recognizing that such limits would have to take into account “the individual situation of non-executive directors and of the company in question,”¹⁶ including such factors as whether the person also holds executive positions or board positions on non-listed companies. The green paper mentions that some member states already limit the number of board mandates.¹⁷

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¹⁷ Ibid.
In its summary of responses, the commission noted that only about a quarter of respondents were in favor of limits and that those who were against limits believed that no measure could take into account all the relevant factors. The Parliament’s resolution stressed that directors must devote sufficient time to their duties, but advised against one-size-fits-all rules while still encouraging member states to set limits on the number of boards on which non-executive directors could serve.

Members were broadly in agreement with the feedback offered on the green paper and with the Parliament’s resolution. One member said, “I sit on a number of boards and can contrast the discussion of the same topic. I benefit by seeing different approaches to the same issues.”

- **Devising a numerical limit is challenging.** Several members noted the difficulty of developing a formula to limit the number of board mandates held by an individual. Serving as a committee chair or on boards that require significant international travel is more time consuming. On the other hand, it could be possible to serve on a larger number of boards of companies in the same sector. Other members questioned if limits should apply to all boards, or only boards of listed companies. One member described some of the unintended consequences of changes to mandate limits in the Netherlands: “Parliament included charitable boards in the accounting for mandate limits. Now it is difficult to find chairs for hospitals or universities.”

  Mr Ducoulombier agreed that a “very fine-tuned figure isn’t meaningful. Three mandates could be more consuming compared to five elsewhere. It is difficult to design a single approach to have sufficient board directors devoting quality time to the board.”

- **Implementation should be done on a case-by-case, comply-or-explain basis.** Members believe that the number of mandates is an issue that “should be cleared with the chair.” Another member suggested that “before accepting a new mandate, a director must get approval from [the] receiving board and from existing board[s],” a suggestion that was broadly supported by other members and which Mr Ducoulombier noted as a “good idea.”

  Members also agreed that directors are ultimately accountable to shareholders on this issue, with one saying that directors have to do “a lot of explaining to do on this issue, not only in the annual report, but one-on-one with shareholders and with the regulators.” Mr Ducoulombier noted that if shareholders played their part, “we wouldn’t need to intervene.”

### The comply-or-explain approach

The final section of the commission’s green paper focused on the comply-or-explain approach for European corporate governance. The green paper did not question the basic validity of the approach, acknowledging that a study of the system has shown that it is widely supported by regulators, companies and investors. The same study, however, also found that “the overall quality of companies’ corporate governance statements when departing from a corporate governance code recommendation is unsatisfactory.”

Explanations have been either non-existent or limited.

Consequently, the commission raised the question of whether more “clear and precise” requirements should be established, including a requirement to describe not only the reasons for the departure but also the
solution that has been adopted instead. The commission also asked whether monitoring bodies should be authorized to check whether the explanations are sufficiently informative and comprehensive. It suggested that “authorities could make the monitoring results publicly available in order to highlight best practice and to push companies towards more complete transparency.”

According to the commission’s summary of comment letters, “the large majority of responses were favourable to requiring companies departing from the recommendations of corporate governance codes to provide detailed explanations for such departure.” At the same time, most of the responses were “against authorising monitoring bodies to check the informative quality of the explanations” or to require more explanations.

The Parliament’s resolution was also supportive of the basic approach, stressing “the need to achieve better functioning of, and compliance with, existing governance rules and recommendations rather than imposing binding European corporate governance rules.” The resolution agreed with the suggestion that companies should explain in a “meaningful way” any deviations from corporate governance codes and the alternative measures implemented instead.

EACLN members mostly supported the comply-or-explain approach. They saw it as effective: “I think it works. A lot of companies comply, and if they can’t, they explain why, and they usually say that they will try to comply.”

Mr Ducoulombier said about comply-or-explain, “I think that it works. I'm impressed by the move to quality and meaningful explanation. In the UK, the FRC [Financial Reporting Council] is trying to improve it by answering the question ‘What is a meaningful explanation?’ I would like to improve the quality of explanations.” Mr Ducoulombier also noted that having organizations such as the FRC and other national regulators monitoring comply-or-explain would be an improvement.

Mr Ducoulombier responded to the concept of directors’ accountability to shareholders on this and other governance issues: “The Financial Times reported that shareholders are rebelling at general meetings, [that executive] pay is unacceptable. Is this limited to the UK? It is developing elsewhere on pay, but the issue goes beyond that. … At the European Commission, we see that we have an uprising; we have been raising this topic for the past five years. We have planted the seed for shareholders to hold boards to account.”

**Conclusion**

Eric Ducoulombier and EACLN members support a pragmatic approach to the development of corporate governance reforms. By considering a range of policy instruments, from light-touch recommendations to heavy-duty directives, the commission is weighing the best approach to improve corporate governance. By limiting the imposition of more stringent regulations only to situations where there is a clear basis in fact to justify action, the commission is fulfilling its responsibility to consider the cost-benefit trade-offs involved in any changes. Finally, whatever is actually proposed by the commission is likely to be implemented on a comply-or-explain basis, albeit with better explanations for non-compliance.

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20 Ibid., page 19.
22 Ibid., page 18.
About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organised and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

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Appendix 1: Participants

The members of the network participating in the meeting sit on the boards of about 20 large-, mid- and small-capitalization public companies. Network members participating in all or part of the meeting included:

- Mr Ángel Durández, Audit Committee Chair, Repsol
- Mr Phil Hodkinson, Board Director, BT
- Mr Lou Hughes, Audit Committee Chair, ABB
- Mr Daniel Lebège, Audit Committee Chair, Technip
- Ms Guylaine Saucier, Audit Committee Chair, Areva and Danone
- Mr Kees Storm, Chairman of the Board, Anheuser-Busch InBev
- Dr Bernd Voss, Audit Committee Chair, Continental AG
- Mr Mario Zibetti, former Internal Control Chair, Fiat Group

The following EY partners participated in the session:

- Mr Christian Mouillon, Global Vice Chair, Assurance
- Mr Mark Otty, Area Managing Partner, EMEIA