TRANSPARENCY INTERNATIONAL
the global coalition against corruption

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TRANSPARENCY INTERNATIONAL'S CONTRIBUTION TO THE EUROPEAN COMMISSION'S GREEN PAPER ON THE EU CORPORATE GOVERNANCE FRAMEWORK

1. Introduction

Corporate governance involves directing and overseeing the values and responsibilities of a company and thereby reducing financial and non-financial (operational) risks by embedding integrity, transparency and accountability within the company. Corporate governance ensures that board members, managers and employees direct and control the firm to provide appropriate results within a code of integrity, balanced to the interests of shareholders and other stakeholders. Further, it serves as a framework to secure investor confidence, enhance access to capital markets, promote growth and strengthen economies.

It is therefore of paramount importance to promote a culture of integrity and good governance at board and all levels of an institution. This can be achieved through soft and hard regulation as well as voluntary initiatives that engender responsible business practice, a greater appreciation and application of risk management, full knowledge of company risk policy and, above all, an embedded culture of ethical business.

Transparency International (TI)'s policy paper, "Strengthening Corporate Governance to Combat Corruption", provides the framework for this consultation submission and can be downloaded here:
http://transparency.org/publications/publications/policy_positions/pp_3_2009_corp_gov

2. Lessons learned from recent corporate governance reforms

The sudden collapses of Enron (2002), Parmalat (2003) and Lehman Brothers (2008) as well as the major discoveries of corruption perpetrated by Siemens (2008) and BAE Systems (2010) have all highlighted the failure of corporate governance structures to combat accounting fraud and corruption. Recent corporate governance reforms have therefore focused on the sources of system failures and their inability to effectively mitigate the full spectrum of company risks related to corruption: financial, operational and social. In response, companies and governments have increasingly pursued mechanisms to prevent the breakdowns that can lead to corruption through regulation that requires independent

directors on boards, separation of roles of the chair and chief executive, strengthening shareholder voting rights, providing clearer accounting standards to prevent fraud and transparency of board and executive remuneration. There is also increasing regulation by governments related to non-financial reporting of environmental, social and governance matters.

3. Key Principles

TI advocates for action to strengthen the transparency, accountability and integrity of corporate governance.

Transparency:
Board and senior executive remuneration and benefits packages should be made public, tied to sustainable performance and determined by independent, non-executive directors. TI supports governments and institutional investors in their call for shareholder approval of individual board and senior executive remuneration packages (including long-term incentives, stock options and pensions).

Companies should publicly report on corporate governance structures and anti-corruption systems, including their overall operations and performance. While many companies dedicate a section in their annual report to describe their corporate governance system, this should be complemented by information on what a business is doing to combat corruption. Coverage of these issues may be alternatively included in corporate citizenship or sustainability reports that companies publish.

Accountability:
External assurance processes should be used to independently verify financial and non-financial data. These are now almost universally mandated by law for company financial reporting. Consideration should be given to requiring assurance work in other areas such as employment, environmental and integrity standards, including anti-bribery programmes.

Shareholder and stakeholder rights should include holding boards, owners and senior management accountable for their actions and respecting the rights of owners. The rights of minority shareholders must also be safeguarded to ensure their voice. Strengthened rights help to counter decisions that could provide a veil for boards to hide their corrupt actions or mask abuses.

Consideration should be given to formalising stakeholder dialogues as a way of improving stakeholder rights. This measure is particularly essential to provide for management's accountability on important business decisions which directly impact stakeholders and corruption risks.

Integrity:
There should be committed and consistent leadership ('tone from the top') that requires the company to perform with integrity, accountability and transparency.

The same good corporate governance standards should be applied across all units of a company and in all countries where it operates. Good corporate governance standards, rules and ethical principles should not be limited to the parent company. Poor practices should not be allowed to be passed off to operating units or exported to other countries. Equally, companies should be committed to improving corporate governance standards in entities where they have influence (e.g. agents, joint ventures and consortia and suppliers), for example through awareness-raising and training.

Specific board responsibilities should be designated to oversee corporate governance as well as ethical and integrity issues. Functions for policy formulation and oversight in the areas of corporate governance and company ethics should be clearly assigned to certain board member(s) and committees. TI strongly supports the creation of independent audit and remuneration committees.

Employees alerting the management of abuses should be protected from victimisation and retaliation. Case after case of corporate whistle blowing has shown that the majority of employees who report claims of corruption and misconduct are victimised and often forced to leave the company. To create a safe haven, TI calls for confidential hot lines, a supportive corporate culture and tailored trainings.

4. The link between corporate governance and anti-corruption

The processes that characterise strong corporate governance systems align in many respects with the key elements for countering bribery that have been outlined in the TI policy positions on corporate governance*.* Anti-corruption principles are a vital part of effective corporate governance because they underline the need to take seriously the long-term viability and **interests of the company and its stakeholders ahead of the interest of the board or management in generating short term gains or inflated remuneration and bonuses.** In short, the institutions must commit to and implement strong ethical principles and responsible management of their businesses.

5. List of questions

5.1 General questions

(1) Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and medium-sized listed companies be established? If so, are there any appropriate definitions or thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.

Small and medium size enterprises (SMEs) face many of the same risks and challenges as larger companies and so should not be exempted from measures designed to improve corporate governance. However, the measures should be scalable and appropriate to the size of the company. There is existing good practice which can be shared. For example, many listed SMEs have a small number of external directors on their board.

(2) Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting development and application of voluntary codes for non-listed companies?

TI supports the idea of promoting the development and application of voluntary codes for private equity and other unlisted companies. The scope of unlisted companies is very wide and includes single owner-manager companies, family businesses, private equity-owned companies, and subsidiary companies. The European Confederation of Directors' Associations (ECODA) has produced a useful report on this matter: Corporate Governance Guidance and Principles for Unlisted Companies in Europe (http://www.ecoda.org/docs/ECODA_WEB.pdf). The ECODA report presents fourteen

principles of good governance on the basis of a dynamic phased approach, which takes into account the degree of openness, size, complexity and level of maturity of individual enterprises.

In general, the codes should cover the areas of corporate governance, corporate responsibility, accountability and transparency. The adoption of such codes would have benefits for minority investors in unlisted companies.

Many state-owned enterprises (SOE) are also unlisted companies, and they have different requirements. They are often characterized by low levels of transparency, underlying political purposes in management decisions, lack of proper motivation for employees and management, and problems of competence and corruption.

Private equity firms in the UK and their portfolio companies have been implementing a new disclosure regime following the guidelines recommended in the 2007 report by Sir David Walker entitled "Guidelines for Disclosure and Transparency in Private Equity". The full set of recommendations can be viewed here: http://www.ecgi.org/codes/documents/wwg_report_final.pdf. The most recent review of the implementation of the report indicates that there has been widespread, if uneven, application of its guidelines. TI sees this approach as a good example of voluntary initiatives in the area of corporate governance standards for private equity, and would recommend the development and promotion of this initiative at EU level.

It is also important to highlight the differences between publicly listed family firms and non-family firms. Recognizing the fundamental differences between family and non-family listed businesses is equally or more important than taking into account their size. As ownership and management overlap significantly in family firms, they are affected more severely by the conflict between controlling and non-controlling shareholders, given that there is a great potential in family firms for manager-owners to expropriate the interests of minority shareholders.

Characteristics such as the involvement in the ownership, governance, and management of the firm as well as the desire to sustain family control of the firm across, are likely to impinge upon several types of behavior. For example, although some contend that in family firms, where leaders are either family members or emotionally linked to the family, attitudes of altruism for the benefit of the organization and its stakeholders may be prevalent, traditionally family firms are seen as having incentives to be less forthcoming with information, and are expected to be associated with lower levels of transparency. Independent directors are as or more important in family firms.

5.2 Boards of directors

The EU needs to consider when developing its policies not only the unitary board but also their application to the two-tier structure structure required in corporations in Germany and some other Europeans countries, consisting of supervisory and executive boards. The comments in this submission are focussed on unitary boards, but many of the same principles should be applied to the two-tier-board system, along with a clarification of their respective roles.

The board of directors is the keystone of a successful corporate governance system. The board of directors or equivalent body is responsible for the stewardship of the company. The board's responsibilities will include approving and monitoring the company's ethical values,

monitoring management control and evaluating senior management. For example, it is the board of directors' responsibility to ensure that management, employees and any relevant external actors are aware of its policy and commitment in respect of a policy of zero tolerance of bribery. It is the role of the board of directors to make a clear statement about the culture which it expects, and the consequences of breaching the provisions of the programme.

Non-executive directors play a crucial role. Their role is to represent the interests of shareholders and stakeholders and therefore need to have a challenging and questioning mindset. These fundamental responsibilities and qualities need to be kept in mind when designing recruitment and other policies.

The Board provides ethical leadership both by example ('setting the tone at the top') and by promoting a corporate governance framework that covers all levels of the organisation. Members of the board, senior management or the owner-manager should be seen by employees and business partners to be active in the support of the governance framework and policies. This requires not only acting clearly with integrity but speaking at employee and external events, communicating through internal and external channels and above all providing leadership and example.

The active engagement of the board in good governance systems is essential. Given its oversight role, the board assumes responsibility for ethical policies, auditing standards (internal and external) and legal compliance systems to counter the risk of abuses. Additionally, increasing a company's commitment to corporate responsibility and sustainability initiatives — as part of overarching commitment to values and ethical standards — can build the level of business integrity needed to mitigate corruption risks. Anti-corruption laws and regulations can never provide sufficiently for detailed implementation of anti-corruption measures nor be flexible enough to meet changing circumstances and risks.

As a general principle, boards should have a balanced composition, with the appropriate mix of experiences and skills necessary to carry out its functions, such as assessing financial risks or corruption risks.

(3) Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?

Yes. This is an important check on executive power and ensures its accountability.

(4) Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? If so, how could that be best achieved and at what level of governance, i.e. at national, EU or international level?

Taking into account the roles and responsibilities of Board members outlined above, TI believes that recruitment policies should reflect the enterprise's commitment to effective and general good governance standards. Directors, whether executive or non- executive, should be alert to potential risks – the non-executives or supervisory board have a particular role to question and challenge executive management or the executive board. Corruption risk should be a regular item upon the board agenda. Several members of board should have a strong risk management background in order to make clear that the ability to manage risks is of paramount importance to the company and is a hallmark of strong leadership skills.

Recruitment policies should have the structures in place to ensure that non-executive and independent members on boards have the skills and capacities to provide oversight of internal controls, financial reporting and executive compensation. This will help prevent conflicts of interest and corruption. There are examples of such provisions in the revised Italian civil code (2003)[1].

While due attention should be given to the importance of recruiting directors with the right skills and backgrounds, this should not blind companies to the problem of "revolving doors" - i.e. the movement of individuals between positions of public office and jobs in the private sector, in either direction. Both the public and private sector should work together in reducing the risk that such recruitment practices undermine trust in government because of the potential for conflicts of interest, for example by making sure that "cooling off" periods are respected.

(5) Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?

(6) Should listed companies be required to ensure a better gender balance on boards? If so,how?

Consistent with the need for a diversity of experiences and skills, TI believes there should also be a diversity of gender in boardroom. TI notes the success of 2003 Norwegian legislation in ensuring a more representative gender balance on Norwegian company boards (44% of board members are women[2]). Other countries in Europe, such as France, Iceland, Italy, Spain are following Norway's lead to implement legislation that require reaching the target of at least 40% female representation on corporate boards in the next few years.[3] These initiatives echo standards set at the international level with the UN Global Compact's "Women's Empowerment Principles", which stipulates that corporations should, "proactively recruit and appoint women to managerial and executive positions and to the corporate board of directors" and assure at least 30% participation in decision-making and governance at all levels and across all business areas.[4]

Standards are also being raised from the reporting side - the Global Reporting Initiative (GRI) in its best-practice guidelines on sustainability reporting, recommends disclosure of gender breakdown of an organisation's board of directors.[5] At the national level, in the United States a recent Securities and Exchange Commission (SEC) ruling stipulated that companies should disclose on whether and how diversity is considered in board nomination processes.[6]

TI believes that in light of recent national and international trends and momentum to ensure better participation of women on corporate boards, EU level quotas require further consultation and consideration.

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[1] Article2381, adequacy of administrative arrangements, art.2387, relating to professional requirements, and art. 2392.
[2] European Professional Women's Network Board Women Monitor 2008
3 Viviane Reding and Françoise Grossetête, "Quotas for Women on Corporate Boards: Why not?" in Les Echos, 02 March, 2011; Nordic Gender Institute, "Iceland introduces gender quotas on corporate boards", 10 March 2010;
[4] UN Global Compact, "Women's Empowerment Principles", April 2010
[5] *Embedding Gender in Sustainability Reporting: A Practitioner's Guide*, GRI & IFC, 2009. [online] < http://www.globalreporting.org/NR/rdonlyres/A98BDFC5-0984-45D1-A778-39405A81C1CD/3532/GRIIFC_Full_Gender1.pdf>
[6] Marcy Murninghan, "Gender Rising", Accountability, March 2011 [online] <http://www.accountability.org/about-us/news/accountability-1/accountability-7.html>

(7) Do you believe there should be a measure at EU level limiting the number of mandates a non-executive director may hold? If so, how should it be formulated?

EU level measures to limit the mandates of non-executive directors need to take into account the increasing liability risk for directors as a result of legislation such as the 2010 UK Bribery Act (Section 14 of the Act allows the prosecution of senior individuals if with their "consent or connivance" a bribery offence was carried out by the company). Therefore the benefits of limiting the number of mandates need to be weighed against the possibility of limiting the pool of qualified and experienced directors.

Consideration should be given to measures that would limit the *duration* of the mandate of directors and ensure that that the board's membership is refreshed periodically. This would reduce the risk of 'group think' and help to promote the contrarian thinking that enables the board to carry out its functions properly.

(8) Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?

The board should consider whether to commission external verification or assurance of its performance. Regular self- and external assessment can define whether new profiles are required in the board to cope with new products or circumstances**.** This external verification should be extended to risk-related financial information, non-financial risk management policies and systems. Where such external verification or assurance is conducted, the board or equivalent body should consider publicly disclosing that an external review has taken place, together with the related verification or assurance opinion, to the general meeting, supervisory authorities and the general public (included in their corporate social responsibility disclosures). See TI's *Business Principles for Countering Bribery* (BPCB - section 5.9: external verification and assurance*)*:
http://www.transparency.org/global_priorities/private_sector/business_principles

Companies should, as a rule, publicly report on corporate governance structures and anti-corruption systems, including their overall operations and performance. While many companies dedicate a section in their annual report to describe their corporate governance system, this should be complemented by information on what a business is doing to combat corruption and any remedial actions that have been taken when necessary. Coverage of these issues may be alternatively included in corporate citizenship or sustainability reports that companies publish.

(9) Should disclosure of remuneration policy, the annual remuneration report (a report on how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?

TI recommends that board and senior executive remuneration and benefits packages should be made public, tied to sustainable performance and determined by independent, non-executive directors. Making such a requirement mandatory would require a thorough impact assessment and analysis of the impact of remuneration on executive performance.

Furthermore, TI strongly supports the creation of independent audit and remuneration committees as an extra layer of accountability and a potentially effective check on unjustified executive remuneration.

(10) Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?

TI supports governments and institutional investors in their call for shareholder approval of individual board and senior executive remuneration packages (including long-term incentives, stock options and pensions).

(11) Do you agree that the board should approve and take responsibility for the company's 'risk appetite' and report it meaningfully to shareholders?

Yes. The board should take responsibility for and comment on material risks to an institution. Openness about the risks and challenges an institution faces and public reporting of these issues should be a fundamental principle. The board or equivalent body should make an independent assessment of the adequacy of risk management and disclose its findings in the institution's Annual Report to shareholders (see BPCP section 5.8 – Monitoring and Review).

One of the key factors behind the collapse of Lehman (2008) was that although the board approved the level of "risk appetite", the CEO overrode that and took on much greater risk. This demonstrates the necessity for monitoring by the board.

The board are ultimately responsible for a company's overall exposure to risk. Therefore the board of directors or equivalent body should demonstrate visible and active commitment to the implementation of the enterprise's risk management programme. The board should be kept informed of the institution's risk profile and strategy. Several members of the board should actively engage in risk management, either through participation on a board-level risk committee or through direct and regular liaison with risk management personnel. Senior management of the enterprise should monitor risk management and periodically review the programme's suitability, adequacy and effectiveness, and implement improvements as appropriate. Monitoring can occur through a newly-implemented risk committee at board level, a direct line of communication with senior risk personnel, or regular submissions to the board of the company's financial and non-financial risk profile. The director of the risk programme and senior risk personnel should receive continuous and appropriate training.

As incidents such as the BP deepwater horizon disaster amply demonstrate, a company's relationship with its subcontractor is fraught with a range of risks and the board should ensure that appropriate due diligence procedures are in place to counter these risks. Specifically, larger companies should ensure that companies that form part of their supply chain also adhere to robust standards of corporate governance.

Should these disclosure arrangements also include relevant key societal risks?

There should not be an artificial distinction between societal and other risks. All risks – including corruption risk – which could have an impact on an institution's declared value should be reported and disclosed in an integrated manner. The large value of the fines that have been imposed on companies that have been found guilty of bribery offences and other corrupt acts demonstrates the significant impact of failing to deal with these risks.

TI believes the risk management that corporate governance systems strive to achieve must equally and accurately assess corruption hazards if the framework is to function. For example, more appropriate and effective whistle blowing procedures by companies (an anti-corruption tool) could have ensured that insiders who recognised the risks and abuses could have had a channel to voice them.

(12) Do you agree that the board should ensure that the company’s risk management arrangements are effective and commensurate with the company’s risk profile?

Yes.

5.3 Shareholders

(13) Please point to any existing EU legal rules which, in your view, may contribute to inappropriate short-termism among investors and suggest how these rules could be changed to prevent such behaviour.

(14) Are there measures to be taken, and if so, which ones, as regards the incentive structures for and performance evaluation of asset managers managing long-term institutional investors’ portfolios?

Asset managers have responsibility for overseeing large flows of funds and also face corruption risks. The evaluation of their performance should also take into account the extent to which asset management firms have anti-corruption systems, appropriate internal controls and state-of-the-art compliance management systems to ensure that decisions are taken with integrity and in the best interests of investors.

(15) Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how?

(16) Should EU rules require a certain independence of the asset managers’ governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

(17) What would be the best way for the EU to facilitate shareholder cooperation?

(18) Should EU law require proxy advisors to be more transparent, e.g. about their analytical methods, conflicts of interest and their policy for managing them and/or whether they apply a code of conduct? If so, how can this best be achieved?

(19) Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

(20) Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors? Please provide details (e.g. objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).

(21) Do you think that minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

The rights of minority shareholders must also be safeguarded to ensure their voice is heard. Strengthened rights help to counter decisions that could provide a veil for boards to hide their corrupt actions or mask abuses.

(22) Do you think that minority shareholders need more protection against related party transactions? If so, what measures could be taken?

(23) Are there measures to be taken, and is so, which ones, to promote at EU level employee share ownership?

5.4 Monitoring and implementation of Corporate Governance Codes

(24) Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

Companies should publicly report on corporate governance policies, structures, and anti-corruption systems, including their implementation, overall operation and performance. While many companies dedicate a section in their annual report to describe their corporate governance system, this should be complemented by information on what a business is doing to combat corruption.

Companies should consult with shareholders and stakeholders in advance of any envisaged departure from the code. TI endorses the position that departures from the standards laid down in the corporate governance codes and frameworks should be fully explained and provide a description of the alternative solutions adopted. This should be a requirement for all public listed companies and should be best practice in private equity firms. A combination of regulatory and voluntary approaches is likely to produce the best results across the board.

The main benefit of this approach will be to provide better quality information to those institutions and organisations whose role is to ensure companies live up their own corporate governance standards. This includes stock exchanges, securities commissions, regulatory bodies and civil society organisations (CSOs) insofar as they have this “watchdog” function. The independence of CSOs from the public and private sectors is particularly valuable in this regard and their monitoring role should be recognised and encouraged.

(25) Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?

Companies need to be aware that in under- or misreporting the corporate governance policies and structures in place, they may be illegally exposing investors and other groups to risks. In general TI believes that external assurance processes should be used to independently verify financial and non-financial data. These are now almost universally mandated by law for company financial reporting and TI has advocated extending them to other areas such integrity standards and corporate governance. Authorising appropriate monitoring bodies to check such statements and request further information would minimise the incentive to deviate from good practice in corporate governance and ensure the quality of information necessary for monitoring organisations to fulfil their role (see Q.24 above). This should be part of a broader suite of appropriate sanctions and penalties available to regulatory and monitoring authorities to ensure compliance with accepted corporate governance standards.

About Transparency International

Transparency International (TI) is the global civil society organisation leading the fight against fraud and corruption. Through more than 90 chapters worldwide (i.e. in almost every EU Member State and in many developing countries world wide) and an international secretariat in Berlin, Germany, TI raises awareness of the damaging effects of corruption and works with partners in government, business and civil society to develop and implement effective measures to tackle it. There is strong evidence of the devastating impact of corruption on poverty reduction and sustainable and participatory development. Advancing development by fighting corruption is therefore one of TI's main areas of expertise and experience.

TI looks forward to discussing these issues with you. If you need further information, please contact:

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