This article will summarise the recent corporate governance developments in Europe, discuss the potential guardians and suggest that companies can meet the challenges facing them by embracing qualitative corporate governance.

The EU’s response to the US governance scandals.

Comments that the problems of Enron, WorldCom and Tyco could not happen in Europe are misleading. Experts have acknowledged that even in Britain, where corporate governance practices are recognised as some of the best in the world, such problems could occur. The key question has been how can standards be improved whilst not damaging the collegiate nature of European boards and inhibiting the decision making process of companies. Not all the current global economic woes can be attributed to a loss of investor confidence springing from a few, albeit high profile, corporate scandals in the US. It is generally recognised in Europe that any introduction of onerous legislation in this field could act as a disincentive to company management and boards to make the business decisions essential for sustainable profitability and economic growth. The European approach to the problems highlighted by the US corporate scandals should not be regarded as an indication of complacency, merely a concern that initiatives be appropriate and sustainable throughout what will, in the near future, be a financial market of 25 countries.

In order to achieve this single financial market the EU introduced a fast track legislative approach following the report of the so called “Group of Wise Men” led by Baron Lamfalussy. The EU Commission issued the Financial Services Action Plan which sets out the road map for the Single Financial Market and regularly monitors progress. Until Enron, the EU Commission had always accepted that corporate governance was a matter for national governments. Thus, the Financial Services Action Plan identified as, the only initiative in this sector, the conduct of a study on the number and nature of corporate governance codes and standards within the Union. This study, published in January 2002 identified more than 35 codes within the EU. Whereas in Britain there several codes, each adding to best practice as the standards were reviewed and improved, in other member states there were competing codes issued by different bodies. However, the study concluded that the number of codes within the EU do not act as a barrier for business within the Union because all the codes were based, to a large extent, on the OECD Principles.

However, reflecting the increasing profile of corporate governance the EU Commission widened the mandate of the Group of High Level Company Law experts, to include review of corporate governance.
The High Level Group Report

The report, delivered over a year ago, focused on the internal elements of corporate governance within the EU. Whilst the report stopped short of recommending an EU directive, it did emphasise the role of the EU in facilitating the co-ordination of corporate governance standards and most significantly their monitoring and enforcement.

The fundamental recommendation was to use disclosure as a regulatory tool. Thus it recommended that each country should designate one corporate governance code as the lead code for compliance by all listed companies. These companies would be required to include in their annual report and accounts a “coherent and descriptive statement” covering the elements of those corporate governance standards and practices they apply and those they do not. As such the report endorses the so-called “comply or explain” approach used in the OECD Principles and several national codes. The key advantage of this approach is that it allows companies flexibility and time to progressively improve their corporate governance standards and recognises that what might be appropriate in one company may not be so in another.

 Whilst companies listed in London are familiar with such an approach, many others will find this a new challenge, particularly if the statements are to be meaningful. Responsibility for this statement is to rest with the board as a whole which under the two tier board structure, adopted by most civil law jurisdictions, includes the supervisory board members.

Slovakia has already adopted this approach and the BSSE listing rules require listed companies to report on their compliance with the Slovak corporate governance code in the current annual reports. This initiative has the active support of the UFT.

The EU Communication and Action Plan

The EU Commission substantially endorsed the Group’s report in a Communication and Action Plan in late May and together these documents set out the EU’s approach to implementation of the report. The Action Plan identifies priorities on a short, medium and long term basis, and uses several tools, “comply and explain”, recommendations and directives.

Recommendations, which the Commission will draft, address some short term priorities namely the strengthening of the role of independent directors, and supervisory board members, the role and composition of board committees and board remuneration. Here one should expect that the “devil will be in the detail” and perhaps we can expect the most radical approach as there will be greatest flexibility in implementation.

Slovakia again is acting on this aspect of the EU Action Plan, with the issue of a consultation document, available from the BSSE website www.bsse.sk, which addresses the roles of the board members and which is based on a similar clarification by the
Netherlands. Comments are welcome on this proposed definition with a cut off date of April 30, 2004.

Directives, will address enhanced disclosure requirements, including collective responsibility of board members for financial and key non financial statements, efficient shareholder communication including cross border voting, disclosure of group structure, cross border mergers, cross border transfer of the company seat and enhanced disclosure by institutional investors of their voting policies. Some commentators are concerned that by seeking to introduce directives the Commission will have to accept standards that are lower than optimal in order to achieve the necessary consensus. One only has to look at the fraught history of the EU takeover directive to understand this concern.

**The guardians of corporate governance - the role of directors?**

There appears to be a general consensus, within the US, UK and the rest of the EU, that the primary guardians of the governance of a company should be the board members. There are many different models, based on the single and two tier approaches. However it is clear that in all of these the most effective guardians will be those board members who are independent of the management of the company.

Traditionally, the role of the non executive board members (whether in a single or two tier structure) has been rather cosmetic. Many regarded the role as recognition of their position in society rather than one with duties and responsibilities. This has changed dramatically in the past decade and increasingly so post Enron where there was considerable criticism that the non executives (highly respected and independent individuals) were asleep on the watch to say the very least.

A recent study on the time spent on board matters by non executives reveals that directors in the US now spend upwards of 19 hours per month on board business, up from 2001 when it was 13 hours. In the UK the figure is currently 25 hours per month. Clearly those who are attracted to the position are taking the position more seriously and preparing for the meetings.

The catalyst for such change has been the increasing perception of risk, both of legal action and reputational risk of individual board members. In the light of this, is it possible to attract suitable candidates for the positions of non executive board member in order that they can be effective guardians of the governance of the companies? Experience in the US and UK indicates that this is now becoming more difficult as candidates realise the more professional nature of the role and the responsibilities it brings. Perhaps this is a positive development for the companies, the fellow board members and the shareholders.

**The role of shareholders?**

As mentioned above, the EU places emphasis on the importance of disclosure as a regulatory tool. If shareholders and potential shareholders are given all the critical information they may make informed decisions over their investments. Furthermore the
process of disclosure encourages companies and its board members to consider in a structured manner some aspects of their business which with the time constraints of all busy people, they may otherwise overlook. Thus as a tool it encourages robust procedures as well as empowering shareholders.

However, this tool assumes that shareholders are willing to accept the responsibilities being thrust on them as guardians of corporate governance. In reality, the small individual shareholder continues to have only a small voice in such matters and thus the burden falls on the larger institutional investors. This inevitably brings us back to an age old debate as to whether it is fair that a small number of shareholders assume the burden, both in terms of time and cost, of actions that will benefit all the shareholders.

Activist shareholders make a virtue out of such an approach and the Calpers website explains how it has enhanced the value of its portfolio through concern over the corporate governance of those companies in which it invests. The McKinsey studies, commissioned by the World Bank, reveal that investors are prepared to pay a premium for well governance companies.

The role of bondholders?

Whilst focus has, to date, been on the role equity investors can play as guardians of corporate governance, many Continental European institutional investors have traditionally preferred to invest in bonds to equities. In the UK Boots the Chemist, took what was considered a bold step of switching its pension fund to bonds only shortly before the equity markets fell. They have set a trend for others. Typically, the corporate bond market sees very little trading as institutional investors prefer to keep such securities until maturity. Generally bond holders have few rights and indeed little interest in the governance of the company so long as they are assured of their investment. However again some of the corporate scandals, including Marconi in the UK, have started to bring about a change of attitude of bond holders. Perhaps this is an early indication that even those institutional investors who hold bonds will seek to ensure proper governance of such companies. The recent case of Parmalat underscores this point also. Thus management and boards may be advised not to ignore such investors and to include them in any constructive dialogue.

The role of the regulators?

Other potential guardians will include the regulatory community, namely the financial markets regulator, government department responsible for companies and the stock exchanges. Each have an interest in ensuring that there are no major governance issues which damage the reputation of the markets. Probably the institution with the greatest challenge is the stock exchange. Clearly any scandal on its market potentially causes damage to its reputation both internationally and domestically. In times when stock exchange consolidation is prevalent, this is something each would be keen to avoid. However, exchanges are competing to attract new issues and indeed retain those larger listed companies which may seek larger and more liquid markets. Thus, to offend such
companies potentially damage the exchange’s business. Thus it confronts a difficult balancing act between the need to ensure good corporate governance standards and the need to show flexibility to its existing and potential new listed companies. This position is even more acute where it is the Listing Authority.

Hence some exchanges have been reluctant to either change, or seek changes to, their listing rules to require all listed companies to sign up to domestic corporate governance codes even on a comply and explain basis. The New York Stock Exchange and indeed the London Stock Exchange are in unique positions given the liquidity of their markets and so both financial centres have been able to keenly promote good corporate governance standards. The EU approach, once implemented, will endorse this and we may see a regulatory race to the top rather than a race to the bottom. The Bratislava Stock Exchange should certainly be applauded for taking such a positive role in promoting good corporate governance and certainly will be regarded well by its counterparts in the EU for this stand.

**Qualitative corporate governance**

Having identified that the required corporate governance standards are rising and that there is increasing scrutiny of quantitative governance by shareholders and regulators alike, what can companies do to reduce the risks they face? Naturally they should ensure that they adopt sound quantitative governance practices as these are now an accepted essential for any company. However, these will be inadequate if that is all a company achieves.

The boards (both supervisory and management) need to embrace qualitative corporate governance in order to reduce the risk of scandal, legal action and the resulting damage to reputation. Clearly this involves embracing the true spirit underlying good corporate governance not merely the trappings.

One tool for introducing this features in both the UK Combined Code and the new draft Netherlands Code, namely board evaluations. In the UK the Combined Code encourages companies to undertake a board evaluation annually, preferably with the assistance of an outside organisation to ensure that it is robust and the role of the independent board members (in Slovakia the supervisory boards) in such an exercise is paramount if it is to be an effective tool for qualitative corporate governance as opposed to merely a quantitative exercise. As such it is an excellent tool for board members keen to fulfil their role as guardians of good governance of the company.