



The Law Society
of England and Wales

The EU Corporate Governance Framework

Response of the Law Society of England and Wales

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Introduction

1. The Law Society (the Society) is the representative body for over 140,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations to regulators and Government in both the domestic and European arena. This response has been prepared on behalf of the Law Society by members of the Company Law Committee, which is made up of senior and specialist corporate lawyers. It is supported in this response by the Law Reform Committee of the General Council of the Bar in England and Wales.
2. The Society is pleased to have the opportunity to participate in this consultation on the EU corporate governance framework. In September 2010, the Society responded to the Commission's Green Paper on corporate governance in financial services. We would like to draw the Commission's attention to our response to that Green Paper. In particular, the core considerations which underpinned our response to the Green Paper on corporate governance in financial services are likewise relevant to the present paper.
3. The Society recognises the importance of good corporate governance within the EU, but, as we stated in response to the Green Paper on corporate governance in financial services, we take the view that corporate governance is a developing and evolving area, which is particularly ill-suited to legislation and prescription. What is right for one company and set of stakeholders may be inappropriate for another and in general the standards of corporate governance expected of, or appropriate for, each individual company need to be proportionate to its size and to the risks which it faces.
4. At a national level, corporate governance codes which are developed in a particular Member State will be suited to the needs of the prevailing ownership structures in that

Member State. We have benefited in the UK from a best practice Code of Corporate Governance, applied on a “comply or explain” basis¹.

5. A soft-law approach to corporate governance based on a code of best practice, together with a “comply or explain” principle, has two advantages. First, it allows standards to be set higher than would be the case if the Member States had to agree on a legislative approach. Second, the standards it sets can be reviewed and adjusted more frequently than would be the case if they were fixed in legislation.
6. Corporate governance requirements may be bolstered, in some sectors, by supervisors/regulators imposing specific compliance requirements. However, we still consider that a code of best practice, chosen by each Member State at national level, is the correct underlying approach to take.

Preliminary questions

Question 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.

Question 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?

7. EU corporate governance measures should take into account the size of listed companies. One method of doing so is to take a “comply or explain” approach insofar as is practical. This enables good governance to reflect the size and complexity of a company and to take account of the nature of the risks and challenges it faces. The Society agrees that a differentiated and proportionate regime should be established.

¹ See the Annexe for the web addresses of the documents to which we refer in the course of this response paper.

8. To give some examples, the UK Corporate Governance Code contains a number of provisions² which do not apply to companies below the FTSE 350³. Furthermore, “comply or explain” codes can be usefully developed for SMEs, as set out in the Quoted Companies Alliance’s *Corporate Governance Guidelines for Smaller Quoted Companies* and in the recent initiative taken by the QCA, together with its French and German counterparts, to devise a set of European Corporate Governance Guidelines.
9. We take the view that it should be for Member States alone to decide whether the corporate governance measures should extend to unlisted companies. Measures at the EU level should focus on promoting the development and application of voluntary codes, which can better reflect the varied range of companies at non-listed level.

Boards of directors

General comments

10. The Society takes the view that measures to increase the accountability of members of the Board of Directors of a company should be left in the hands of the Member States. It is for national law, and the companies themselves, to determine the accountability of Board Members.

Question 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?

11. The Society believes that as a general corporate governance matter, it is desirable for the functions of chairperson of the board of directors and the chief executive officer to be kept separate. This approach is reflected in the UK Corporate Governance Code, which contains the principle that there should be a clear division of responsibilities at the head

² For example, Sections B.1.2, B.6.2 and B.7.1 of the UK Corporate Governance Code.

³ The market index incorporating the largest 350 companies by capitalisation which have their premium listing on the London Stock Exchange.

of the company between the running of the board and the executive responsibility for the running of the company's business⁴.

12. The UK Code further provides that the role of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board⁵.
13. In the case of regulated sectors, such as financial services, the regulatory and supervisory authorities with whose rules companies must comply may well have a role to play with each particular company in ascertaining whether the composition of its board presents any corporate governance issues. Such an approach is likely to be more flexible and achieve better results than a blanket prohibition.

Board composition

14. The following three questions should be answered together.

Question 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?

Question 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?

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

15. The Society takes the view that legislation at EU level is not the appropriate route to ensuring that company boards are suitably diverse.

⁴ Section A.2 of the UK Corporate Governance Code.

⁵ Provision A.2.1 of the UK Corporate Governance Code.

16. As an equal opportunities employer itself, the Society is in favour of a corporate governance code (for example) such as the one currently in force in the UK which requires the board and its committees to have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. It is in a company's interests to have the right range of skills⁶.
17. The UK has taken a number of initiatives in this respect. The chairman of the board is responsible for ensuring that the board is effective and appropriate⁷. The nomination committee likewise has a responsibility to evaluate the balance of skills needed for board membership⁸. The need for ongoing training and a focus on skills has also been emphasised⁹.
18. However, this is not something that requires legislation at an EU level.
19. With regard to the recruitment process to be followed for the appointment of individual board candidates, the Society believes that the search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender. This view is in line with the relevant supporting principle of the UK Governance Code, which requires that there should be a formal, rigorous and transparent procedure for the appointment of new directors to the board¹⁰. We prefer an approach which uses a corporate governance code and a "comply or explain" principle, rather than a set of rules laid down by legislation.
20. Question 5 does not specify whether the diversity policy relates to the board or the company generally. We assume it is intended to refer to the board. We would not be in favour of legislative measures in this respect. We would support a corporate

⁶ Indeed, recent research on diversity, carried out by Eversheds LLP, has suggested a link between the number of female directors on boards and the ability of the companies studied to withstand the impact of the financial crisis.

⁷ Section B.6 of the UK Corporate Governance Code.

⁸ Section B.2.2 of the UK Corporate Governance Code.

⁹ Section B.4 of the UK Corporate Governance Code.

¹⁰ Section B.2 of the UK Corporate Governance Code.

governance code requirement for listed companies to disclose if they have a diversity policy, and, if this is the case, to describe its objectives and report regularly on progress. However, we see no need for a requirement to report on the main content of that policy.

Availability and time commitment

Question 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?

21. As a preliminary comment, the Society would like to indicate that we assume that this question was addressing only mandates for non-executive directorships of listed companies. Non-executive directors of a listed company may also serve on the boards of subsidiaries of that company and on the boards of companies that are not listed.
22. The Society would not be in favour of an EU measure which sought to impose any such limit on the number of mandates that a non-executive director may hold, nor the number of boards upon which such a director may sit.
23. Furthermore, we feel that it would be particularly inappropriate to impose a “one size fits all” rule at either EU or national law level. Such a rule would run the risk of specifying either too great or too small a number of mandates, no matter what number is specified. The appropriate number in any given situation will vary depending on the companies and individuals concerned.
24. The UK Corporate Governance Code has as a principle that all directors should be able to allocate sufficient time to the company to discharge their responsibilities¹¹. It also contains specific provisions dealing with the positions of the chairman and non-executive directors. These provisions aim to ensure that they will have the necessary available time to fulfil their roles effectively. The Society feels that this is a more appropriate way of addressing the issues raised by this question.

¹¹ Section B.3 of the UK Corporate Governance Code.

Board evaluation

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

25. The UK Corporate Governance Code has recently introduced a provision that an evaluation of the board of FTSE 350 Companies should be externally facilitated at least every three years¹².
26. It is also a principle of the UK Code that the Board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.¹³ The Society feels that this is the right approach to take and that other national corporate governance codes should be encouraged to include similar provisions.
27. We also feel, however, that such external evaluation is inappropriate for smaller listed companies. This is because of the cost of external evaluation and the limited number of bodies which are qualified to provide such services.
28. The Society does not think that it would be sensible to legislate for a requirement for external evaluation, but we can see that in sectors which are regulated, any relevant supervisory authorities should have the power to require this for a particular company.
29. Finally, we do not think that there should be a requirement that the evaluations themselves should be made available to shareholders: such availability might well prove counter-productive, in that it would discourage directors from providing frank views and would encourage the reporters to make their reports less direct and specific. However, we would be in favour of the possibility of high-level reporting mechanisms to confirm whether evaluations have taken place and whether any action was recommended following the evaluation.

¹² The Walker review recommended that a “board should undertake a formal and rigorous evaluation of its performance, and that of committees of the board, with external facilitation of the process every second or third year”.

¹³ Section B.1 of the UK Corporate Governance Code.

Directors' remuneration

30. The following questions should be considered together.

Question 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?

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

31. We note that the UK regime currently contains a number of requirements concerning disclosure.
32. First, the Companies Act 2006 requires quoted companies¹⁴ to provide a detailed remuneration report, containing information specified from time to time by subordinate legislation¹⁵.
33. Second, Rule 9.8.8 of the UK Listing Authority's Listing Rules also contains detailed requirements for the disclosure of remuneration in the accounts of a company listed in the UK.
34. Third, the UK Corporate Governance Code contains the general principle that there should be a formal and transparent procedure for developing policy on executive remuneration, and for fixing the remuneration of individual directors¹⁶.
35. The Society is not in favour of any further measures being taken at EU level with regard to remuneration for directors of listed companies. We would prefer to see better application of the current recommendations, rather than the introduction of any new recommendations in this field. We believe that the UK approach, as summarised above,

¹⁴ A "quoted" company is a company whose equity share capital (a) has been included in the official UK list, or (b) is officially listed in an EEA State, or (c) is admitted to dealing on either the New York Stock Exchange or Nasdaq (Section 385(2) of the Companies Act 2006).

¹⁵ Sections 420 to 422 of the Companies Act 2006.

¹⁶ Section D.2 of the UK Corporate Governance Code.

provides a satisfactory model. In particular, it is important that a company's focus should be on the quality rather than the quantity of the information disclosed, with a view to ease of use for investors. This issue was reflected in the Financial Reporting Council's 2009 report, *Louder than Words*, which noted that many users had observed that remuneration reports were too dense to be useful¹⁷.

36. The Society takes the view that shareholders should be encouraged to take an active interest in their company's remuneration policy and to express their views on the policy put forward.
37. In the UK, this is reflected in the Companies Act 2006, which requires (in the case of a quoted company) that an ordinary resolution should be proposed at each annual general meeting to approve the directors' remuneration report for the financial year¹⁸. It is important to note that while the requirement for the resolution is mandatory, the resolution itself is advisory only¹⁹. The Society is strongly of the view that to require a mandatory vote either for the approval of remuneration policy generally, or for the remuneration packages of individual directors, would be inappropriate and unduly onerous.

Risk Management

38. The following questions should be considered together.

Question 11: Do you agree that the board should approve and take responsibility for the company's "risk appetite" and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?

Question 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?

¹⁷ *Louder than Words*, p. 55.

¹⁸ Section 439 of the Companies Act 2006.

¹⁹ Section 439(4) of the Companies Act 2006.

39. As a preliminary observation, we do not believe that there is a common understanding of the words “risk appetite”. If any requirement in relation to risk appetite is to be imposed, the term will need to be more clearly defined with regard to the information which companies would be expected to provide.
40. The UK regime currently includes several requirements relevant to risk management. The Companies Act 2006 (reflecting the provisions of the Fourth Company Law Directive) requires a company’s directors’ report to include within the business review a description of the principal risks and uncertainties facing the company²⁰.
41. Moreover, the UK Corporate Governance Code provides that boards are to be responsible for determining the nature and extent of the significant risks the company is willing to take in achieving its strategic objectives, and for maintaining sound risk management and internal control systems²¹. Risk management and internal controls are required to be subject to review at least annually, and the board is to report to shareholders that the review has been undertaken.
42. The UK Corporate Governance Code requires the appointment of an audit committee of independent non-executive directors whose roles and responsibilities include review of the company’s internal financial controls and, unless addressed by a separate risk committee or the board itself, review the company’s internal controls and risk management systems.
43. The Code also states that overall responsibility for risk management and internal control is a matter for the board²², with the audit committee bearing the responsibility for review and reporting on systems²³.
44. The UK Financial Reporting Council has produced guidance for directors on the internal control requirements of the Code. This is known as the Turnbull guidance and covers, *inter alia*, how boards are to report on their group’s risk management processes and

²⁰ Section 417 of the Companies Act 2006.

²¹ Section C.2 of the UK Corporate Governance Code.

²² Section C.2 of the UK Corporate Governance Code.

²³ Section C.3.2 of the UK Corporate Governance Code.

systems of internal control²⁴. The Society does not believe there should be a legislative requirement for boards to report on their internal control systems. However, it would be desirable to have a corporate governance code requirement to make a statement about the adequacy of internal control systems, along the lines recommended under the UK Turnbull guidance.

45. The Turnbull guidance also provides that ongoing responsibility for risk management and internal control is to be devolved to the audit committee, unless devolved to a separate risk committee.
46. The Society considers that the Code rightly imposes responsibility on the board of directors for setting the company's risk profile and strategy. However, we strongly feel that the precise role of the board of directors in this connection should not be prescribed by law, and especially not by measures taken at EU level. It is for individual boards to determine what is appropriate in the context of their own companies.
47. In relation to BOFIs, in the UK the Walker review's recommendations proposed the establishment of a board risk committee, which would have responsibility for oversight and advice to the board on current risk exposures and future risk strategy. These proposals have been adopted by the FSA, with effect from 1 May 2011. We think that it is sensible for all companies, particularly large companies, to consider the value of establishing such a committee, in addition to its audit committee.
48. However we do not think that it is appropriate to impose a mandatory legal requirement in this regard. If the scale and complexity of the company is such that the full board (assisted by the audit committee) can adequately manage responsibility for risk, then there is no reason why it should be legally obliged to appoint a separate risk committee.
49. The Society takes the view that it is appropriate for the annual report to shareholders to cover the Company's approach to risk strategy and the risk profile it wishes to adopt (for example, as part of its explanation of its business model) and for that to be the subject of debate at the annual meeting if shareholders so wish. However, we do not believe that

²⁴ Section four of the Turnbull Guidance.

this should be compulsory. Shareholders of traded companies already have the right to ask questions at shareholder meetings under the Shareholders Rights Directive.

50. In our view, a board cannot be asked to “ensure” that the risk management arrangements are effective. Its members should only have to take reasonable care to review what the arrangements are, to monitor how they work in practice and, if there are problems, to agree the steps the executives will take to deal with these. These duties are best determined within the framework set out in national law.
51. We consider that the primary role of a company’s risk reporting and disclosure should be to allow investors to assess the risks posed to the company’s business and financial position arising from (a) its own operations and (b) external factors (such as political risks and natural disasters) and to assess the management’s stewardship of the company. We do not include within those categories of risk broader “societal risks” arising from a company’s operations, except insofar as those inevitably carry risks for the company itself (e.g. to its reputation).
52. As an aside, the Society feels that it should at this juncture point out that there is an important difference between Corporate Governance (which deals with how boards and stakeholders behave towards each other) and disclosure to stakeholders *per se*. The two are not synonymous and should not be confused with each other.
53. Regarding “societal risks”, disclosure should be relevant to the users. The Financial Reporting Council stated in its 2009 report, *Louder than Words*, that: “[t]here is a need to re-establish the principle that corporate reports should be designed for their primary purpose – providing investors with information that is useful for making their resource allocation decisions and assessing management’s stewardship. This is consistent with the IASB’s latest thinking on the conceptual framework for financial reporting, which identified the primary users of corporate reports as ‘present and potential equity investors, lenders, and other creditors’²⁵. For the purposes of this response paper, the Society (like the FRC) considers “users” to be capital providers and their advisers.

²⁵ *Louder than Words*, p.10.

Shareholders

Short-termism of capital markets

Question 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.

- 54. The Society does not believe that there is a general regulatory bias towards short-termism among investors.
- 55. To the extent that there is short-termism, we do not in any event consider that it can be dealt with via regulatory measures because it is a market-driven issue.

The agency relationship between institutional investors and asset managers

- **Short-termism and asset management contracts**

Question 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?

- 56. The Society takes the view that that incentive structures for, and performance evaluation of, asset managers is a matter for the contractual arrangements between the asset managers and institutional investors. It is not a matter for regulation.
- 57. In the UK, the Financial Reporting Council (FRC) published its Stewardship Code in July 2010. The Stewardship Code aims to enhance the quality of engagement between institutional investors and companies, to help improve long term return to shareholders and the efficient exercise of governance responsibilities, by setting out good practice on engagement with investee companies.

58. The Code sets out principles for institutional investors and operates on a “comply or explain” basis. Institutional shareholders are asked to disclose on their website how they have applied the Code, or to explain why they have not done so.
59. To date, there are over 150 signatories to the Stewardship Code. A recent survey by the Investment Management Association (IMA) showed widespread adherence by UK institutional investors to the Stewardship Code principles and illustrated the increased involvement that institutional investors now have in relation to voting and stewardship activities²⁶.
60. We believe that initiatives like the Stewardship Code are more likely to be effective than legislation at EU level. We also note that the European Fund and Asset Management Association has also recently published a Code for Governance which is similar in approach to the Stewardship Code. Other EU Member States should be encouraged to adopt similar codes on a “comply or explain” basis. Such codes should then be given time to show whether they are effective before any new EU legislation is considered.

- **Lack of transparency about the performance of fiduciary duties**

Question 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?

61. The Society does not believe that any EU legislation to require further monitoring is needed. As mentioned in our response to Question 14, the Stewardship Code has recently been introduced with a view to improving engagement with investee companies. Asset managers in particular are now required by the rules of the Financial Services Authority (FSA) to disclose whether or not they have committed to the Stewardship Code. However, we again note that some time will be needed to see the effects of the code manifest themselves fully.

²⁶ *Adherence to the FRC's Stewardship Code*, p.2 to 5.

Other possible obstacles to engagement by institutional investors

- **Conflicts of interest**

Question 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?

62. The introduction to Question 16 asserts that “[c]onflicts of interest in the financial sector seem to be one of the reasons for the lack of shareholder engagement”. We query whether there is any evidence which would back up such an assertion.
63. We do not think that there is any need for new legislation in this area. We note that there are already existing provisions under MiFID²⁷ in relation to the independence of asset managers. When acting as agents for institutional investors, asset managers will in any event have a duty to act in accordance with the interests of their principal and to ensure that conflicts of interest are properly handled.

- **Obstacles to shareholder cooperation**

Question 17: What would be the best way for the EU to facilitate shareholder cooperation?

64. The Society recommends that the existing EU legislation on acting in concert should be reviewed to ensure that it does not hinder effective shareholder cooperation. One example of a provision which should be reviewed is the Acquisitions Directive²⁸ and the guidance issued under it.

²⁷ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments [...] (OJ 2004 L 145, p. 1).

²⁸ Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector (OJ 2007 L 247, p. 1).

65. We do not think that any further systems are necessary to enable EU proxy solicitation, particularly when the Shareholder Rights Directive²⁹ has only recently been implemented and its full effect has not yet been seen.
66. Finally, the Society does not see any obvious problems with the transmission of relevant information, particularly given the level of information that is now available, on a free access basis, on regulatory and corporate websites, including regulatory announcements and shareholder documentation.

Proxy advisors

Question 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?

67. The Society has a number of reservations about such a proposal. First, it would be difficult to identify and define “proxy advisors”. Second, it is not clear how EU law would apply to them, as they often operate on an international basis – both inside and outside the EU. To pose a simple question by way of example, would the applicable law be determined by reference to their principal place of business or by reference to that of the companies they cover in their proxy advice?
68. A voluntary code of conduct might be helpful, but we are not in favour of legislative measures in this area.
69. One issue the Society has identified is that some institutional investors may be more likely to rely on voting preference advisory services without being prepared to invest the time in a dialogue with companies, which may lead to those services exerting a disproportionate influence. However, we stress that the solution to this problem lies with the institutional investors concerned. The Stewardship Code provides that institutional investors should engage with the companies in which they are investing³⁰, and where

²⁹ Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies (OJ 2007 L 184, p. 17).

³⁰ Principle 3 of the UK Stewardship Code.

convinced by the explanations given by those companies as to the reasons for a particular course of action, they should ensure that their proxy advisors vote accordingly.

70. For that reason, we take the view that the regulation of proxy advisors will not necessarily assist in improving shareholder engagement.

Question 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?

71. The Society does not feel that it is necessary to impose further legislative measures on proxy advisors.

Shareholder identification

Question 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).

72. The Society supports current EU legislation such as the Transparency Directive³¹, which enables listed issuers to identify those interested in their shares.
73. We believe that the disclosure of interests in shares made to the market under Chapter 5 of the UK Disclosure and Transparency Rules (which implement the Transparency Directive) provides an adequate mechanism for identification of those with interests above 3% of an issuer's share capital. We do not think that there would be sufficient benefit in identifying holders below that threshold level to justify the cost involved.

³¹ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (OJ 2004 L 390, p. 38).

74. We are, however, aware that divergences in practice between the Member States means it can be difficult for issuers to obtain information about underlying interests. This is not conducive to good corporate governance and shareholder engagement.
75. We feel that it would be appropriate to address this on a EU wide-basis, and we would support such a measure in principle.
76. However, we do not believe that it is appropriate to establish a system at EU level to allow or require listed issuers to communicate directly with the underlying smaller shareholders. In the UK we have legislation which enables those shareholders who are holding shares on behalf of underlying beneficiaries to nominate those underlying beneficial holders to the company to enjoy information rights. The information rights allow the indirect holders to receive all shareholder communications directly³². To the larger UK companies which already allowed those who were not registered shareholders to join their “mailing list” for shareholder communications (and there has been limited engagement by the intermediaries who hold shares), the change in law did not have a huge market impact. Since the relevant documentation is now available on company's websites and on national storage mechanisms, it is not clear that a legal right to receive mailings is necessary.
77. We believe that any system to allow or require communication with indirect shareholders should be a “pull” system (information sent at the request of the recipient) rather than a “push” system (information sent by the company). We would not wish to see any system imposed which would require further unsolicited and therefore potentially unwanted hard copy communications which are expensive for issuers.
78. We understand that there are issues of empty voting in other Member States. We do not think that empty voting is an issue of shareholder identification.
79. The Society believes that shareholders are sometimes inhibited in discussing their views with other shareholders because of their concern that they will be treated as acting in concert, which may have damaging consequences. In the UK, for example, concert

³² Section 146 of the Companies Act 2006.

parties can be subject to onerous requirements under the UK City Code on Takeovers³³. We think it would be helpful for Member States to be asked to consider any provisions in their local law or practice which may give rise to such concerns, with a view to removing them. If Member States were to share their approaches with other Member States, this could help to develop a consensus of approach. We think it is particularly important that this is dealt with at a national level because of the differing approaches to control in the Member States, the differences between company laws at the national level and the fact that decisions on acting in concert are very fact-sensitive. Measures opposing these provisions at EU level, such as those in the Acquisitions Directive, should also be reviewed.

80. We do not believe that any increased identification of shareholders to issuers would benefit co-operation between shareholders. The Society feels that it would be impractical for companies to be required to identify a large number of small shareholders. Below the current level at which shareholders are identified (3% in the UK and 5% under the Transparency Directive) we believe that shareholder engagement is only workable through the more structured methods established by company law: putting members' resolutions at annual general meetings, calling general meetings and raising questions at annual general meetings, for example.

Minority shareholder protection

- **Scope for engagement and the functioning of “comply or explain” where there is a controlling or dominant shareholder**

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

81. The Society believes that the rights of minority shareholders are most appropriately protected through company law at a national level, rather than through corporate governance codes, which we believe are better suited to a “comply or explain” approach.

³³ In this respect, the Takeover Panel has issued a Practice Statement (No 26, Sept 2009, *Shareholder Activism*) aimed at addressing market concerns about concert parties. The FSA has also published a statement on shareholder activism.

82. In the UK, we do not believe that minority shareholders need additional rights to protect their interests effectively in companies with controlling or dominant shareholders. If other Member States do need to make amendments to their company law regimes we believe that this is best achieved at national level, through national company law regimes which can be tailored to local company structures and markets.

- **Protection against potential abuse**

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

83. Companies with a premium listing in London are already subject to additional constraints on related party transactions. These include: an announcement obligation, a requirement for a shareholder circular (including a statement by the board that the transaction is fair and reasonable as far as the security holders of the company are concerned and that the directors have been so advised by an independent adviser acceptable to the Financial Services Authority), shareholder approval and a requirement that the related party and their associates do not vote on the relevant resolution³⁴. We believe that these rules provide a high level of comfort for minority shareholders.

84. However, it should be noted that the UK Listing Authority offers both standard and premium listing, and therefore a choice can be made by issuers as to whether to offer their securities with or without this protection. Companies are required to indicate on all announcements whether or not the listing is premium or standard and so investors are aware of which level of protection is being offered.

85. At a European level, the Society takes the view that it would be appropriate for the EU to encourage this approach for listed companies, perhaps by way of a recommendation. However, for establishing a set of detailed rules in this regard, it would be best to leave matters to the discretion of the national regulators in each Member State.

³⁴ Rule 11 of the UK Listing Authority's Listing Rules.

Employee share ownership

Question 23: Are there measures to be taken, and if so, which ones, to promote at EU level employee share ownership?

86. The Society believes that the role of the EU in this area should be to facilitate employee share ownership rather than to promote it. Whether or not it is financially sound for employees to hold shares in their employers is a complex question requiring thoughtful and fact-sensitive analysis.

The “comply or explain” framework – monitoring and implementing corporate governance codes

87. The “comply or explain” approach appears to the Society to be ideally suited to the control of corporate governance arrangements for listed companies. We believe that the market's understanding and acceptance of the need for and benefits of proper engagement with “comply or explain” reporting on corporate governance codes has developed significantly over the past few years.
88. At this point, we feel that it is appropriate to emphasise that corporate governance is something more than just an exercise in box-ticking for companies. A “comply or explain” principle adds significant value to a system of corporate governance, in that it makes companies seriously consider the issues raised by their chosen course of action. In some respects, a “comply or explain” principle, properly applied, is even better than regulation: the latter may be counterproductive, in that it could well lead to a reduction in the amount of thought companies put into corporate governance matters.
89. Adequate engagement by shareholders is in many cases some way behind, but has received a boost in the UK following the introduction of the Stewardship Code and the increased prominence of stewardship in the public awareness.

90. Given that there has been a lot of change in the area over the last few years and there is a time lag in the effects of any change becoming apparent, it may be that historic studies are not compelling evidence for further change.

Question 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?

91. The UK Code states that the “comply or explain” approach is the trademark of corporate governance in the UK.
92. The Code consists of principles, rather than a rigid set of rules. This allows a company to justify its choice to depart from a provision of the Code in particular circumstances, if it considers that good governance can be achieved by other means.
93. This system means that the quality of the explanations given in corporate governance statements is very important: the Code requires a clear and careful explanation to shareholders of the reasons for taking an alternative approach. It also states that companies should aim to illustrate how its practices are consistent with the principle of a provision and contribute to good governance.
94. The Society welcomes the steps taken in some Member States to highlight examples of good – and bad – explanations. “Good” and “bad”, in this case, are linked to whether the explanation provides sufficient detail for shareholders to form a view on whether they approve of the reason for the departure or not. These steps would appear to be a more suitable approach.
95. However, we do not think that introducing more detailed requirements would be a positive step. The essence of the explanation is that it is a chance to depart from the *pro forma* solution suggested by the relevant code. It is therefore important that the explanation of that departure is not made into a boilerplate exercise. Furthermore, as companies do not always adopt alternative solutions, there should be no requirement to describe such solutions.

Question 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?

96. If there is a continuing issue with a lack of engagement by shareholders in some companies with widely held shares, a review by a body such as the Financial Reporting Review Panel in the UK, relating to the quality of the reporting may be beneficial. As a matter of best practice, if a Member State were to have such a body, a random selection of reports could be reviewed annually (rather than those of all companies) and a report of general trends published. A random selection of reports may also be published to encourage good behaviour. However, this type of initiative would be better left in the hands of the Member States.

Annexe: References

General Sources:

UK Corporate Governance Code: <http://www.frc.org.uk/corporate/ukcgcode.cfm>

Stewardship Code: <http://www.frc.org.uk/corporate/investorgovernance.cfm>

Listing Rules: http://www.fsa.gov.uk/pubs/other/listing_rules.pdf

Companies Act 2006: <http://www.legislation.gov.uk/ukpga/2006/46/contents>

Questions 1 & 2:

Corporate Governance Guidelines for Smaller Quoted Companies (September 2010):

<http://www.theqca.com/shop/guides/26706/corporate-governance-guidelines-for-smaller-quoted-companies-september-2010.thtml>

European Corporate Governance Guidelines:

<http://www.theqca.com/news/briefs/44421/european-corporate-governance-guidelines-produced.thtml>.

Questions 4, 5 & 6:

The Eversheds Board Report: summary at <http://press.eversheds.com/Press-releases/Smaller-more-diverse-and-independent-boardrooms-new-Eversheds-report-identifies-the-criteria-for-company-success-8c3.aspx>

Question 8:

The Walker Review final recommendations:

http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

Questions 9 & 10 and Questions 11 & 12:

Louder than Words: <http://www.frc.org.uk/press/pub1994.html>

Questions 11 & 12:

Turnbull Guidance:

<http://www.frc.org.uk/documents/pagemanager/frc/Revised%20Turnbull%20Guidance%20October%202005.pdf>

Question 14:

Adherence to the FRC's Stewardship Code: <http://www.investmentfunds.org.uk/press-centre/press-releases/press-release-2011-05-25>

Question 20:

UK Disclosure and Transparency Rules: <http://fsahandbook.info/FSA/html/handbook/DTR>

UK City Code on Takeovers and Mergers: <http://www.thetakeoverpanel.org.uk/the-code>

Takeover Panel Practice Statement No 26, Sept 2009, *Shareholder Activism*:

<http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/PS26.pdf>

FSA statement on shareholder activism:

<http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/110.shtml>

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