esma European Securities and Markets Authority

The Chairman

Date: 20 July 2011
ESMA/2011/219

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RE: Green Paper – The EU corporate governance framework

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as by enhancing investor protection.

ESMA has considered the European Commission's Green Paper *The EU Corporate Governance Framework* (the "Green Paper"). Many of the questions raised in the Green Paper are within the remit of corporate law, rather than securities law. Consequently, ESMA and indeed most of the national regulators currently have little or no jurisdiction on these matters and indeed corporate governance codes are often wholly or partially the remit of non-public authorities or trade bodies. In pursuing its objectives set out in the paragraph above, ESMA has taken the view that it would like to contribute its views on the corporate governance issues raised in the Green Paper based on its and European competent authorities' knowledge and experience as securities regulators.

ESMA welcomes the European Commission's consideration of this important area and the opportunity to comment on the issues raised in the Green Paper. Our detailed comments are set out in the Appendix to this letter and are arranged so as to answer specific questions in the Green Paper. We hope you will find them useful. However we would like to take the opportunity in this covering letter to raise some more general principles supporting our answers and some issues that whilst not raised in the Green Paper itself, have come to our notice during the discussions we have had preparing our response.

Firstly, the corporate governance framework in Europe varies significantly between Member States depending upon the interaction between company law, listing rules and codes. Consequently, codes on their own cannot work without regulation and the challenge is to obtain the right mix of the various options available.

Flexibility within the frameworks is required to allow for this different mix, to cater for the different needs and types of issuers and markets and to accommodate the different corporate governance issues that arise as a result of different ownership and shareholder structures. Flexibility is therefore essential and should be preserved. European securities regulators recognize however that there could be value in developing a common set of minimum corporate governance principles for listed companies across the EU, allowing for enough flexibility to take into account the differing frameworks existing within the EU. These principles would represent a minimum level of compliance. Member states would be at liberty to implement more stringent requirements where they feel this is appropriate.

The different corporate governance systems that have developed reflect various challenges and needs found in individual Members States. ESMA therefore believes that flexibility and diversity of solutions is also necessary in order to accommodate the different corporate governance issues that arise as a result of different ownership and shareholder structures.

ESMA believes that the "comply or explain" approach is recognised in the EU as an important tool for delivering good corporate governance. Although we concede that there is room for improvement particularly in the area of monitoring and enforcement to ensure: monitoring of disclosure practices and enforcing disclosure rules in order to attain the level of disclosure needed to identify agency issues; compensating for the limited activity by shareholders where, for example, block holders are widespread and where there is limited ownership and poor involvement by institutional investors; improving the availability, completeness and quality of the information and increase the level of transparency needed for effective monitoring by shareholders.

Secondly, in a number of areas in the Green Paper (most strikingly in those questions dealing with risk management and with asset managers for example), the Commission appears to have taken the approach that the areas it has identified in its previous work in relation to corporate governance in financial institutions will translate across to listed companies more generally with little or no modification.

In general ESMA would recommend caution in seeking to extend proposals that the Commission may have considered appropriate for financial institutions to public companies generally and should rather reconsider what it believes the protections are that investors in listed companies really need independently of its conclusions on financial institutions.

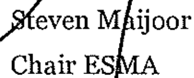
In addition, across the EU the role of shareholders is fundamental to achieving effective governance within issuers and regulators should be conscious of the need to align their oversight with that exercised properly by shareholders in all governance issues.

This leads to our final observation: the Green Paper in general focuses on individual items (e.g. diversity, board effectiveness, short-termism) without putting such issues into a context or framework that is cohesive. Indeed often even though we agree with the general "worthiness" of such aspirations, without a context it is difficult as a regulator to assess whether the impact of any proposed intervention in the area concerned is justified by the benefit.

Consequently ESMA believes that before the Commission takes decisions on how to move ahead in many of the areas covered by the Green Paper, further thought needs to be given to how in general principles of good corporate governance for listed companies can be articulated.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,



Steven Maijoor
Chair ESMA

APPENDIX – ESMA's detailed answers to the questions in the European Commission Green Paper on the EU corporate governance framework

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.

1. There is a strong consensus view within European securities regulators that companies on a regulated market should not be subject to differing standards of corporate governance. This said the key issue would be to identify a set of principles that listed companies could as a minimum be subject to, taking account of the differing frameworks existing within the EU. A certain element of flexibility (one of which may be the size of the company) could be built into these principles. These principles would represent a minimum level of compliance; Member States would be at liberty to implement more stringent requirements where they feel this is appropriate. The principles should also be subject to regular review and updating (in relation to this please see our response to questions 24 and 25).

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?

2. There is broad consensus within European securities regulators that the focus should be on listed companies. ESMA is primarily focused on listed companies but recognises that promoting development and application of voluntary codes for non-listed companies is worthy of further consideration particularly where such companies have wide public ownership (e.g. through employee share schemes) or are traded on a public market.

BOARD OF DIRECTORS

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?

3. ESMA acknowledges the importance of drawing a distinction between the functions and duties of the chairperson of the board of directors and the chief executive officer. These functions should be clearly divided and should preferably not be combined in one person.

4. ESMA favors measures to strengthen a division in functions and duties of the chairperson of the board of directors and the chief executive officer on a recommendation basis bearing in mind that mandatory implementation of such a requirement may not be appropriate in smaller companies with limited shareholder bases and indeed that the potential risks of combining the two roles can, in some cases, be mitigated by other counterbalancing measures.

5. Needless to say, introduction of measures in this area would not involve changes to systems that have already successfully addressed this issue (e.g. The two tier system).

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?

6. It is important for (listed) companies to have a well composed board of directors suiting to the company's profile as a key to its functioning in assuming its role and particularly its supervisory role. Primarily, it is the responsibility of the company to establish the skills they need and assess the suitability of candidates and the chairman's responsibility in particular to ensure the quality of the board. This assessment should also look at the composition of the board as a whole, not just at the individual candidate in isolation.

7. ESMA recognizes the importance of diversity on boards. The ultimate priority must be to ensure that there is sufficient experience and technical knowledge and independence on the board. Drawing on individuals from a wide range of backgrounds could help to achieve this aim. Having a more diverse board may help deliver better regulatory outcomes, as increased diversity produces a wider range of perspectives, thought and approaches to solving regulatory problems and can help avoid the danger of 'group think'.

8. When considering measures to enhance diversity on boards, the geographical positioning and complexity of the operations of the listed companies should be taken into account as should the size of market in which the listed company operates.

9. ESMA does not consider a European-wide introduction of mandatory fixed quota on gender to be the right instrument for all markets and legal traditions to enhance more gender-balanced composition of boards. ESMA believes that this strategy would potentially lead to putting individuals on to boards simply to meet "targets" in some circumstances. Focus should concentrate more on expanding the pool of talent available to companies generally from which they can make board appointments.

10. ESMA would support discussions on how board diversity could be reflected in regulation to ensure that boards focus on having effective strategies to increase their board room diversity.

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?

11. ESMA agrees with the underlying premise that directors need to devote sufficient time to their role.

12. We do not believe that introducing a European-wide absolute limit on the number of mandates held would be the best way to achieve this result. More oversight within a company regarding what non-executive roles directors are taking on coupled with greater transparency and accountability of the performance of the board are perhaps areas that the Commission should further consider.

13. ESMA recommends that any measures taken in this regard should be on a recommendation basis. Requirements should allow enough flexibility, taking into account the size and complexity of the company and also the specific mandate (responsibilities and work load on other boards). Further, it should be taken into account whether other/further mandates by a board member which he or she holds are within the same group of companies or not.

14. Special attention should also be given to directorships held by executive directors, whose functions by definition require greater involvement.

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?

15. ESMA generally acknowledges the benefits of regular (annually / every three years) external evaluation of boards as a way to ensure or increase the efficiency and quality of the board's functioning and would support the introduction of measures that would encourage companies to undertake such reviews. Disclosure of the process and the main results of [internal and/or] external evaluation of the appropriate board to shareholders should be an integral part of this. We have however concerns that the value of such reviews is as yet unproven and therefore would stop short of making such reviews mandatory.

16. Regard should be had to the nature of the reviewer's expertise and any links to the company or its managers would have to be closely examined.

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?

17. ESMA believes that disclosure of the annual remuneration report and individual remuneration of executive and non-executive directors is useful information for investors and should be a key principle.

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

18. Whilst acknowledging that there may be value in allowing shareholders to vote on such issues, ESMA is aware that practice in member states is very diverse in this area. We would therefore recommend that further work is done to discover whether there is value on an EU wide basis in such a vote before a decision is taken. We would be happy to assist the Commission in performing such analysis.

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?

19. It is important that the board sets a company's risk appetite and its risk strategy, taking into account the interests of the shareholders it represents. Also a meaningful and consistent risk reporting to shareholders is important. Boards should ensure that control systems are effective and in accordance with the company's risk profile. The board should then monitor how the executive delivers the strategy and holds the executives accountable, and be responsible for reporting on performance. The results of all these findings should be reported on a regular basis to shareholders.

20. However regular reporting of risk appetite as such may be more appropriate to a financial institution where managers are in a position to alter risk appetite according to the desires of investors rather than to non-financial companies more generally. In non-financial companies, the risks concerned are often more to do with the nature of the business itself and a decision regarding whether those risks – or more often than not the risk of the risk itself happening – will have already been taken when the company decided to enter the particular market. These are better termed "risk factors" than "risk appetite". Consequently ESMA believes that effort should be made to develop a set of key

principles governing how these risk factors are disclosed by non financial companies to encourage greater comparability across companies and across markets.

21. Consequently, recent developments in national legislations, in corporate governance codes or in supervisory regulations have defined and clarified the role of boards with regard to its responsibility on risk strategy, management and ESMA doubts whether at this time new rules are necessary.

SHAREHOLDERS

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.

22. Recent evidence suggests not only that short-termism is both statistically and economically significant in capital markets, but also that it appears to be rising[1]. However, even if this tendency towards short-termism constitutes an economic reality, ESMA cannot point to any specific EU legal rules that may contribute to inappropriate short-termism among investors.

23. Any regulatory response in this regard should be balanced. At least theoretically, both long-term and short-term investors take expectations as to the long term value prospects of a firm into account in their investment decisions. For this reason, long-term value creation can still be supported in an environment with shorter holding periods.

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?

24. ESMA generally supports the European Commission's view on the role of institutional investors in strengthening corporate governance.

25. However, it does not seem to be too clear how the involvement of institutional investors in the corporate governance of the investee companies can be imposed via regulation and how the protection of different interests could be properly addressed. Fund and portfolio managers have fiduciary duties to their clients because they are subject to regulations according to which, the protection of the interests of their clients prevails and not that of the companies in which they invest.

26. Normally, the investment objectives of any asset manager are subject to an agreement between the asset manager and its investor which specifies the investment strategies. Hence, what institutional investors can be encouraged to do is to evaluate the performance of asset managers over a longer time horizon, and to remunerate asset managers using incentive structures that reflect the long term nature of their investment.

27. In this context, policies and disclosure of the incentive structures of asset managers are of great importance. However, additional EU level measures for asset managers do not seem to be necessary in this respect. The Alternative Investment Fund Managers (AIFM) Directive, which Member States must transpose by 2013 at the latest, provides a framework for manager remuneration policies, using measures applied to credit institutions (under the Capital Requirements Directive) as a model. The purpose of the framework is thus to ensure that the manager remuneration policy is consistent with funds' risk profiles and operating rules. The variable portion of managers' pay is also required

[1] HALDANE, A., *The Short Long* (2011), available at www.bankofengland.co.uk/publications/speeches.

to factor in future earnings. As a result, remuneration should be subject to deferred payment and may be reduced or withheld in the event of negative performance.

28. The European Commission is planning to amend the Undertakings for Collective Investments Transferable Securities (UCITS) Directive to regulate the remuneration of UCITS managers along the lines of the approach adopted by the AIFM Directive. Accordingly, incentive structures for managers that take account of performance evaluations will factor in long-term fund performance. The aim is to ensure that the framework for the remuneration of market participants (credit institutions, investment firms, fund managers) is consistent and captures the specific characteristics of different activities.

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?

29. ESMA shares the view according to which transparency (with regard to strategies, costs, trading and exercise of voting rights) is of great importance and could lead to more effective monitoring of asset management companies by investors. However, it is not clear that additional laws are required in this area.

30. Indeed, Directive 2009/65/EC (UCITS IV) and the AIFM Directive covers already the topics of remuneration (with extensive reporting and disclosure requirements regarding investment policy, asset valuation and risk and liquidity management), remuneration (requiring incentive structures in line with interests of investors and remuneration serving an effective risk management), and conflicts of interests.

31. Specifically regarding strategies for the exercise of voting rights, article 21 of Commission Directive 2010/43/EU, implementing Directive 2009/65/EC (UCITS IV) requires management companies to elaborate appropriate and effective strategies for determining when and how voting rights attached to instruments held in the managed portfolios are to be exercised in order to ensure that the voting rights are exclusively exercised for the benefit of the investment fund concerned. Moreover, a summary description of those strategies as well as details of the actions taken on the basis of those strategies shall be made available to investors.

32. Additionally, the reporting and disclosure rules under MiFID (articles 19, 27 to 34, 41 and 42 of Directive 2007/73/EU) are also relevant.

33. With regard to asset managers' engagement with investee companies, it should be recognized that they have a duty to at least exercise vigilance regarding the shareholdings they manage.

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?

34. ESMA is of the opinion that the creation of a level playing field for all asset managers in this regard, by ways of a horizontal approach, is important.

35. However, additional EU measures seem unnecessary. On the one hand, precise provisions governing the management of conflicts of interest are provided for in the UCITS IV Directive and will be applicable from 1 July 2011 to management companies managing UCITS (cf. Article 17 et seq. of Implementing Directive 2010/43/EC). On the other hand, similar provisions are likely to be established as part of the AIFM Directive's implementing measures. Conversely, MiFID also covers conflicts of interests under articles 13(3), 18, and 21 to 23 of the Directive 2006/73/EU.

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

36. ESMA considers that institutional shareholders should be able to act collectively with other investors where appropriate. Consultation between shareholders can help increase the level of insight into the corporate governance of an issuer, as it can help shareholders convey their views to an issuer more effectively and clearly. This applies in particular with a view to preparations for a general meeting of shareholders, whereby consultation can lead to the granting of proxies and voting instructions.

37. However, it should be noted that, in recent years, the trend within the EU was to expand on the existing rules on acting in concert in takeovers and in the transparency context, in order to prevent abusive behavior by shareholders.

38. This being said, ESMA would welcome clarification on the application of acting in concert in the Transparency Directive and/or the Takeover Bids Directive in this context.

39. In any case, ESMA is of the view that future amendments to existing rules should be thoroughly assessed, notably in order to determine to what extent the dialogue between shareholders could constitute an abusive behavior.

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?

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?

40. ESMA supports transparency for proxy advisors. Avoiding conflict of interests between proxy solicitors and investee companies is also an important issue.

41. ESMA is currently preparing a discussion paper on proxy advisors which is expected to provide additional input for the Commission.

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).

42. ESMA considers that the Transparency Directive already enables issues to identify their shareholders satisfactorily.

Question 21

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

43. ESMA generally supports the protection of rights of minority shareholders. However, it considers the distinct legal systems' specificities of Member States need to be taken into account as different rules, according to different legal backgrounds, can achieve similar results and levels of protection.

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

44. ESMA considers that merely enhancing the transparency about the execution by management of related party transactions ex-post is insufficient, as ex-post transparency does not prevent transactions which disadvantage minority shareholders from being carried out. Rather than disallow related party transactions, shareholders and/or independent and non-interested board members could be given the opportunity to vote (ex-ante or ex-post) on the larger transactions, to ensure minority shareholders' rights are upheld.

45. Therefore, ESMA would like to mention that the European Corporate Governance Forum has issued a Statement on Related Party Transactions for Listed Entities, dated March 10, 2011.

THE "COMPLY OR EXPLAIN" FRAMEWORK – MONITORING AND IMPLEMENTING CORPORATE GOVERNANCE CODES

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?

46. It is recognised that explanations for noncompliance are the very essence of the universal application of the codes and there is broad support for requiring companies to provide detailed explanations in those cases. This means requiring individual explanations of each recommendation the company departs from. General, global or aggregated explanations should not be acceptable because they are inconsistent with the "comply or explain" principle.

47. It may be justifiable in particular circumstances to give an alternative to following a provision, if good governance can be achieved by other means. Where this is the case, the reasons should be clearly and carefully explained to shareholders, who may wish to discuss the position with the company.

48. However, as ESMA has commented before an important element lacking however is a common set of principles encapsulating all elements that are considered good governance for listed companies is lacking in the EU.

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?

49. Although some Competent Authorities recognise that there has been some improvement during the recent years, ESMA is of the view that the completeness and the quality of the explanations provided by companies could be improved.

50. With regards to improving the quality of the disclosures, this responsibility should in first instance be with shareholders who are the sole parties who can judge the usefulness of disclosures to their voting decisions. Monitoring bodies can however contribute to improving the completeness of disclosures and can issue guidance on the fulfilment of disclosure requirements.

51. As stated above, there is a general support for independent monitoring. The minimum monitoring activity should consist of checking and periodically publishing the results, including educational information on good and bad practices. Informal contacts between the monitoring body and companies should also be carefully considered as should powers to obtain and if necessary require companies to disclose additional information.

52. ESMA recognises that all these activities by the monitoring bodies – where they exist - have contributed to relevant improvements in the completeness and quality of the information provided by companies about their corporate governance.