Corporate governance as a driver of growth in the digital era

Key findings of the 16th European Corporate Governance Conference that took place in Riga on 13 May 2015

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Introduction

Why does corporate governance matter to Europe? It matters because well-run companies are more likely to attract greater investment opportunities, which enables them to innovate and expand, and to generate wealth and jobs for the economies in which they are based.

Conversely, badly run companies not only deter foreign investment in their own businesses, they also discourage foreign investment more broadly within their jurisdictions, restricting economic growth and stifling social mobility.

It is not hard, then, to see why EU policymakers view corporate governance as an important weapon in their arsenal when it comes to the battle for international competiveness in the fast-moving technological age. At the same time, they — along with policymakers in other markets — have honed in on governance as one way to prevent the destructive events of the financial crisis from being repeated.

This pervasive focus on corporate governance, both in the EU and beyond, explains why the Organization for Economic Co-operation and Development (OECD) is reviewing its *Principles of Corporate Governance* to ensure their continuing high-quality, relevance and usefulness. The principles are, of course, one of the Financial Stability Board's 12 key standards for international financial stability.

It also explains why the EU is in the process of revising the Shareholder Rights Directive to give shareholders the right to vote on director remuneration policies as well as significant related party transactions that could impact a company's balance sheet.

Given the complex economic, political, social and technological context that today's businesses are operating in, the theme of the 16th European Corporate Governance Conference was extremely apt. Entitled *Corporate Governance: a tool to increase competitiveness in the digital era*, the conference took place in Riga on 13 May 2015 and attracted over 200 representatives, made up of 20 different nationalities, from both the private and the public sector. Another 600 delegates also followed the conference live on the Internet.

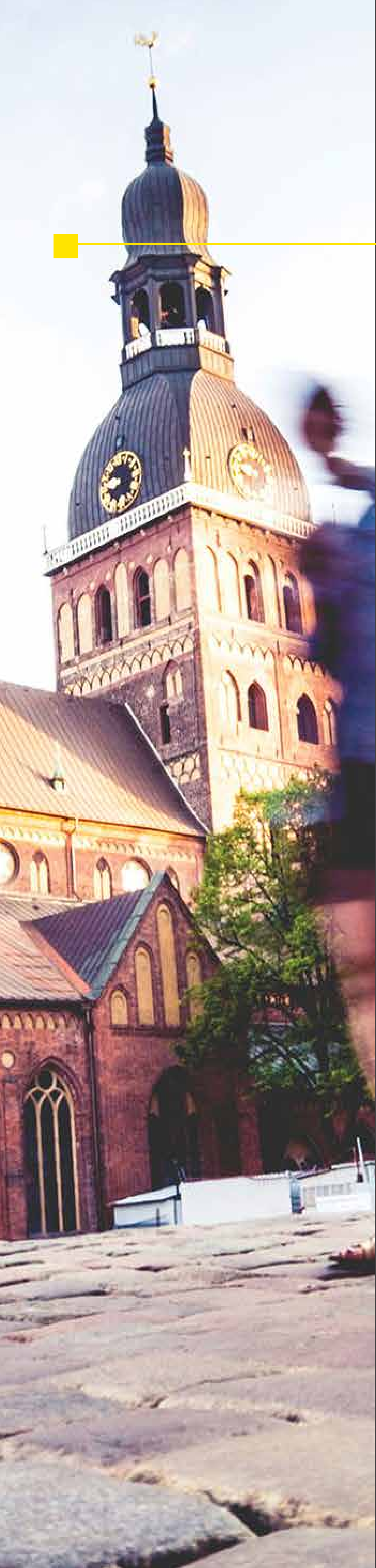
The overall aim of the conference was to collaborate and to share best practice on corporate governance, with a particular focus on competitiveness, the opportunities and threats presented by technology, the views of institutional shareholders and the relationship between the board and the audit committee. Together, conference panelists and participants debated some important topics including the challenge of finding the right balance between principles and rules, fairness and efficiency, flexibility and harmonization, and scrutiny and interference.

Throughout the discussions, the overriding message from conference participants was that since the financial crisis, the regulatory pendulum in the world of corporate governance seems to have swung too far in the direction of hard law. So, in the interests of achieving greater competitiveness and treating corporate governance as a driver of growth, rather than as a barrier to growth, we need to find a way to ease the pendulum back the other way while maintaining appropriate checks and balances.

You will be able to reach your own conclusions after you have read the key findings of the conference, which are outlined in this report.

Jeremy Jennings

Regulatory & Public Policy Leader, EY, EMEIA



Foreword

As the holder of the EU Presidency during the first half of 2015, it was Latvia's great pleasure to host the 16th European Corporate Governance Conference, which was supported by EY.

Latvia, with our population of just over two million people, may be one of the smaller states within the EU, but our reputation for good corporate governance is strong. Indeed, Latvia's sound legal framework and corporate governance practice were highlighted when the country was invited to begin accession talks with the OECD in October 2014.

We take a keen interest in corporate governance because we understand the crucial role that it plays in terms of attracting investment and resources from investors who live beyond our borders. Corporate governance stimulates entrepreneurial activity and fosters social cohesion, enabling us to successfully compete in world markets.

Equally, the same principle applies to the EU, which Latvia joined in 2004. Although the EU is both the world's largest investor and the world's biggest recipient of foreign direct investment (FDI)[1] , it cannot afford to become complacent. Since the financial crisis struck, competition between markets to attract FDI has intensified, meaning the EU must present its case to investors ever more convincingly.

The conference that took place in our capital, Riga, in May gave thought leaders from both business and the public sector the opportunity to exchange ideas about the direction that corporate governance in Europe is taking and to raise the issues that they would like policy makers to address. The event was challenging, insightful and thought provoking, and it covered a broad and interesting range of topics.

I hope you enjoy reading about the conference findings here.

Dzintars Rasnačs

Minister of Justice of Latvia

1. http://ec.europa.eu/economy_finance/international/globalisation/fdi/index_en.htm

01 Governance as a competitive tool

During the opening panel discussion, panelists debated the merits of taking a principles-based approach or a rules-based approach to governance in an era of intense global competition.

"The Shareholder Rights Directive engagement policy is a tax on voting, which is precisely what we should avoid."

Professor Dr Dirk Zetzsche

Propter Homines, Chair for Banking and Securities Law, University of Liechtenstein

"We ought to have a commonly applied system of electronic voting Europe-wide."

Kerrie Waring

Managing Director, ICGN

Daniel Blume, Senior Policy Analyst at the OECD, Directorate for Financial and Enterprise Affairs Division, moderated the opening session on governance as a competitive tool.

View from the OECD

The OECD views corporate governance as a key tool for competiveness, which is why it is reviewing its Principles of Corporate Governance, Blume told conference participants in his introductory speech.

Sound corporate governance gives confidence to investors that a company is well equipped to implement strategy, mitigate risk, ensure effective accounting and controls and make appropriate disclosures. For this reason, well-governed companies are attractive to investors and they tend to get access to cheaper capital.

Blume explained that the Financial Stability Board has endorsed the OECD Principles of Corporate Governance as a global standard for sound financial systems and it has asked the OECD to revise its principles to take into account lessons from the financial crisis and other recent experiences. The new principles will be formally launched in September 2015. For more on the revised principles, see box below:

ICGN principles

Kerrie Waring, Managing Director of the International Corporate Governance Network (ICGN), explained that ICGN's members are primarily institutional investors who represent combined assets under management in excess of $26 trillion.

The ICGN has its own Global Governance Principles, which were drawn up by its members. While these principles have their origins in the original OECD principles that were drawn up in 1998, they are more granular in that their recommendations are specifically targeted towards corporate directors and institutional investors.

Waring emphasized that any code that belongs within a "comply or explain" regime is only effective if institutional investors and other stakeholders are willing to engage with companies to find out about why deviations have occurred. She added that stewardship is only effective if shareholders are equipped appropriately with the rights to be able to engage. For this reason, the ICGN is very supportive of the EU's Shareholder Rights Directive, particularly the enhanced rights for shareholders – the so-called "say on pay" and influence over related party transactions.

ICGN does not support the new provisions that were inserted into the Shareholders Rights Directive by MEPs at the start of May. These provisions relate to the use of control-enhancing mechanisms as a way to reward shareholders for keeping long-term holdings. ICGN believes that these provisions will disenfranchise minority investors around the world.

Policy perspective

Laila Medin, Deputy State Secretary on law policy at the Ministry of Justice of Latvia, and chair of the working party on the Shareholder Rights Directive, explained that member states have differing view on the directive, which needs to be taken into account.

She also highlighted that two main groups of shareholders exist – concentrated ownership and dispersed ownership – and these pose different challenges to legislators. As a result, while certain basic provisions can be included in the law, there needs to be flexibility to take into account differences in shareholder ownership structures and varying views among member states.

With dispersed ownership structures, lots of small shareholdings exist, which means that none of the shareholders has a major influence. This entrusts the greater power to management, however, so the challenge is to ensure that management acts in the best interests of the shareholders and that sufficient control mechanisms exist. These ownership structures also pose the risks of short-term thinking and short-term pressure to deliver returns.

With concentrated ownership structures, which are found in Latvia, for example, one or two shareholders may own the majority of shares in the company. In these cases, legislators are focused on protecting minority shareholders against the misuse of power by majority shareholders with regard to related party transactions, executive remuneration policy and dividends.

Medin said that she believed that the working party has achieved a balanced approach in terms of addressing the issues posed by both dispersed and concentrated shareholder ownership structures. She highlighted that identification of shareholders is very important, particularly in the case of small shareholders. Companies need to know who they are so that they can communicate with them. This particularly matters if there are intermediaries in the chain.

The Nordic experience

Per Lekvall, Member of the Swedish Corporate Governance Board and Member of the Policy Committee of the European Confederation of Directors Associations (ecoDa), explored how to find the right balance between rules and voluntary recommendations.

He highlighted some of the main findings of a study carried out in 2014 to try to define a common Nordic model of corporate governance, based on existing rules. The Nordic countries share a lot of the fundamental basics for corporate governance: their listed companies tend to have highly concentrated ownership structures, they also share a similar regulatory set-up and they have a common governance structure that differs from other European models.

The Nordic corporate governance model is designed to allow strong owners to largely control their companies, Lekvall explained. This is based on the belief that because these owners have invested a lot of money in the company, they are competent at what they are doing and take a long-term view. As a result, all shareholders benefit, including minority shareholders.

Lekvall said that the system works well – evidence of this is the fact that the excess value of controlled shares – which can be quite substantial in other markets – is virtually zero in the Nordic states. "It's a successful strategy to ride on the back of a strong, dedicated controlling owner," he concluded, which is why investors in Sweden will willingly buy shares in family-controlled businesses such as retailer H&M.

Finally, Lekvall concluded that EU regulations developed over the past decade do not sit well with the Nordic approach to corporate governance. The European Commission has pursued harmonization and issued prescriptive rules for corporate governance in Europe, he noted, which has caused challenges for regulators, owners and boards.

His view was that the EU should define its own overall principles for good governance in Europe but be tough about ensuring that each country introduces national regulations to implement these principles.

Responsibilities of the shareholder

Professor Dr Dirk Zetzsche, Propter Homines Chair for Banking and Securities Law at the University of Liechtenstein, talked about the role of the shareholder in ensuring effective corporate governance.

He observed that voting was the most important part of shareholder engagement but it is also the part where most difficulties exist at present. The costs of voting are significant to many small and medium-sized investors, but the benefits are very uncertain, which results in passivity. He noted that there was evidence of short-termism on the part of small and medium-sized investors.

The challenge, he said, was to make voting the cheapest solution rather than the most expensive one. Costs arise from the use of voting advisors, getting the vote through the depository chain to the issuer and forgoing income from stock lending. Meanwhile, the Shareholder Rights Directive policy on shareholder engagement introduces new costs.

The cheapest way to respond to the Shareholder Rights Directive is essentially not to vote, said Professor Zetzsche, because if shareholders don't vote, they don't have to explain how they engage. "The Shareholder Rights Directive engagement policy is a tax on voting, which is precisely what we should avoid."

Professor Zetzsche suggested that shareholder engagement could be improved by removing the red tape and regulation that is associated with voting – for example, voting disclosure. He added that there should be legal requirements asking to investors to justify why they don't use their voting rights, otherwise there is an inclination towards passivity. Shareholder identification also needs to be as fast and as cheap as possible.

The problem of stock lending also needs to be addressed, Professor Zetzsche said, because there are many barriers to voting in the current stock-lending procedures.

Panel discussion

The panel discussion began with a debate on stock lending. Professor Zetzsche highlighted that stock lending does not just take place high up in the depository chain; it also takes place lower down. Also, some stock lending takes place without the consent of investors, which puts their investment at risk. He emphasized that stock lending is not actually lending. In reality, it is a full "sale" with a commitment to give the asset back at a certain price. Stock lending can be problematic in shareholder voting situations because the shares have to be bought back at a certain price, which is costly.

Waring concurred with Professor Zetsche's views that voting needs to be cheaper and more accessible. "For me, the other must-have is efficiency," she said. "There is absolutely no need for us to still be relying on human intervention to cast votes. We ought to have a commonly applied system of electronic voting Europe-wide."

There is a perception that governments and regulators make rules because they enjoy the process of doing it, Medin commented, but sometimes principles remain on paper and aren't followed in practice. She also highlighted the important role of the audit committee as an internal control mechanism to ensure that the company follows good practice.

Lekvall said that he was a strong believer in strict legislation as a basis for good corporate governance, but he added that soft rules and guidelines are very useful as a complement to hard law. The difference between hard law and soft law, he said, is that hard law defines the minimum level that every company has to abide by but, through self-regulation, companies can have a higher level of ambition. By raising this level progressively, corporate governance is improved more efficiently than by relying on legislation alone.

On the topic of "comply or explain" codes, Lekvall said that these work well if they are interpreted and applied in the right way. Unfortunately, however, they are understood differently in different parts of Europe. He said that some jurisdictions seem to lean towards having 100% compliance, which is a big mistake since the point of self-regulation being an ambition for better practice is lost. He said around half of Swedish companies comply with their code entirely and the other half make one or two explanations. "We are worried that there is too much compliance, not the other way round," he observed.

Professor Zetzsche said intermediaries bear the costs of improved corporate governance, but they don't necessarily benefit from it. This is why they don't invest in technology. As a result, he called for those involved with drafting the Shareholders Rights Directive to ensure that there is an open draft that can allow for a future model without intermediaries within the chain.

Medin underlined that the current draft of the Shareholders Rights Directive emphasizes that, if possible, the company should talk directly to its shareholders, avoiding the chain of intermediaries.

Audience poll*

Q1. How effective are each of the following in helping to improve corporate governance?

Q2. Where might future actions be taken to improve corporate governance?

*Polling was done on a scale of 1-6 where 1 = not very effective and 6 = very effective

Revisions to the OECD's Principles of Corporate Governance

The OECD's revised Principles of Corporate Governance, which will be published in September, will include chapters dealing with the corporate governance framework, shareholders, stakeholders, disclosure, and boards of directors.

The revised principles also introduce new topics, and bring greater clarity and emphasis to others, including a new chapter on the role of institutional investors, stock markets and other intermediaries.

There are five main areas where there are new developments in the principles:

1. Supervision and enforcement

The new principles have an increased emphasis on supervision and enforcement. The governance of financial regulators and the role of stock exchanges have both received increased attention.

2. Role of shareholders

The provisions relating to the role of shareholders have been updated to include possibilities for shareholders to express their views and influence executive and board compensation (the so-called "say on pay") and to be able to participate in shareholder meetings without being physically present. The rules for approval of related party transactions have also been strengthened.

3. Role of incentives of financial intermediaries

The new chapter gives increased attention to the treatment and the role of incentives to financial intermediaries. In order to promote the alignment of incentives and to manage conflicts of interest, increased disclosure is recommended for intermediaries and service providers, such as institutional investors, asset managers and proxy advisors.

4. Disclosure

Te revised principles reinforce guidance on disclosure. Building on existing financial statement disclosures, they recognize recent trends to disclose information on sustainability issues, payments to governments, information on beneficial ownership and related parties, and on board member responsibilities.

5. Responsibilities of the board

The revised principles provide increased guidance on the responsibilities of the board, including with regard to risk management and compensation. They also address the role of board committees, the internal audit function, board evaluation and training. Measures to enhance gender diversity are mentioned.

02

Governance in a digitalized world

In this discussion, panelists debated the potential for digital technology to transform the corporate governance landscape.

> "Everything will be connected – the watch, the toothbrush and maybe even the wine glass."
>
> **Dr Peter Katko**
>
> Head of IP/IT Law, Germany, Switzerland and Austria, EY

> "We have to reconcile different public policy objectives, for example, good corporate governance, with data protection."
>
> **Jeroen Hooijer**
>
> Head of Unit, European Commission, DG Justice, Corporate Governance, Company Law and Anti-Money Laundering

By 2020, the digitalized world should be a €9 trillion market with more than 200 billion interconnected things, was the attention-grabbing introduction to this session from panel moderator Dr Peter Katko, Head of IP/IT Law, Germany, Switzerland and Austria at EY. "Everything will be connected," he predicted, "the watch, the toothbrush and maybe even the wine glass."

He reminded conference participants that the European Commission has identified the creation of a Digital Single Market as one of its 10 political priorities. So what are the implications of this strategy for corporate governance?

The drive for digital

Jeroen Hooijer, Head of Unit, European Commission, DG Justice, Corporate Governance, Company Law and Anti-Money Laundering, observed that digital tools have the potential to reduce corporate governance costs.

He highlighted that some existing company law rules date back to the 1970s and do not allow for the benefits of digital technologies. Therefore the European Commission is planning to assess to what extent the existing company law framework is fit for the digital age. The first step will be a public consultation to identify which areas of corporate governance and company law will get the greatest benefit from technological solutions, particularly in a cross-border context. It is also planning a conference on the digitalization of company law, which will take place in Brussels on 2 October 2015.

Meanwhile, the separate proposal for single member private limited liability companies (also known as sole traders) will introduce an obligation at European level for member states to provide online registration for these companies on a cross-border basis. Online registration for single member private companies already exists in 16 member states, including France, Latvia and Poland, but not in the other 12 states.

The Commission is also looking at the interconnection of business registers in order to facilitate access at European level to information about all limited liability companies.

The corporate governance framework is more recent than the company law framework and already takes into account modern technologies to some extent, Hooijer said. The existing Shareholder Rights Directive foresees the publication of certain information online and it will require member states to allow companies to opt for electronic voting.

Hooijer identified electronic voting and electronic participation in general meetings as an important work stream for the Commission to focus on. Others are the provision of electronic tools for the exchange of information between the company and the shareholders, and electronic platforms for collaboration among shareholders.

A common standard

Susannah Haan, Secretary General of EuropeanIssuers, the organization representing most European quoted companies, addressed the issue of whether we will see a common standard for digital shareholder meetings and digital shareholder information exchange in the near future.

She noted that in many countries, more international shareholders had joined the market recently and more shareholders were investing cross-border. The result of this was that national systems that had worked well when they just had domestic shareholders and local companies were struggling to cope with the sending of information from the company along the chain to the investor.

In some countries, and in some systems, companies have direct knowledge of who the shareholder is – the shareholder may be on the register that the company holds, which makes direct communication easy. But as the number of international shareholders increases, there are more holdings behind nominee accounts where communication is indirect along the chain of intermediaries.

EuropeanIssuers has worked with other organizations within the industry, including central securities depositories, intermediaries and investors, to try to agree some common standards of communication along the investment chain. The idea of having common standards is to make communication more efficient and, ultimately, electronic. At present, a large number of manual processes still exist.

Haan highlighted the balance between where regulation can work and where industry best practice can work. Regulation can work once what you want to do is quite clear, she said. When it's not clear what you want to do, industry best practice is probably more effective because you need to get something that will work across all member states, which is not easy to achieve.

Haan was concerned that the revised Shareholder Rights Directive favors intermediaries rather than giving the right to companies to know who their shareholders are.

What do investors think?

Sue Harding, Director with the UK Financial Reporting Council's Financial Reporting Lab, reflected on whether digital information is important for investors. She explained that the Financial Reporting Lab, which is an initiative of the Financial Reporting Council, is helping to drive innovation in market practices by facilitating discussions between companies and investors.

The Lab is currently working on a project to see what the digital future looks like in corporate reporting. It started by looking at the "digital present" and worked with eight companies and 20 investors to talk about which corporate communications are being provided digitally to investors now. She said that both retail and institutional investors are making extensive use of various platforms to access information.

Overall, pdfs are the most important method for investors looking to access corporate information directly. That's because they offer a good mix of what is provided in the hard copy annual reports while having additional benefits that can only be achieved through digital means: timeliness (they can be instantly downloaded), portability and the ability to search. Investors make less use of the report information on company websites and of apps. Importantly, investors value comparability and they want to review information in a similar way across multiple companies.

Harding suggested that there are a variety of characteristics of existing digital information, especially pdfs, that need to be included in future tools.

Finally, she observed that there was limited governance oversight on the production of digital reporting. Instead, governance activities tend to be focused on the production of hard copy annual reports.

The Baltic experience

Introducing Latvia's experience of digitalizing governance processes, Guna Paidere, Director General of the Register of Enterprises of the Republic of Latvia, highlighted that Latvia had worked hard to make electronic communication possible by creating the preconditions to go digital. Latvia has one of the fastest internet networks in the world, electronic identification, secure electronic signatures and different online services provided by the government. Security is key to making electronic communication possible. She said it is just a matter of time before electronic services become the usual standard.

Rimantas Žylius, Managing Director of Norway Registers Development AS and former Minister of Economy in Lithuania, said that the concept of corporate governance as a competitive tool was a key driver behind Lithuania's state enterprises reform. Corporate governance mitigates the risks that businesses bear, he said.

He added that public institutions, such as revenue authorities, are under huge pressure to be more efficient and they also collect a lot of data from a wide range of sources. As institutions become more powerful and have control over more information, the issue for them is that they have 21st Century technology with 20th Century governance. For example, the CEO of a revenue authority will be appointed and dismissed directly by a minister. There are also risks with misuse of information, since 20th Century legislation governs use of data. For example, under privacy legislation, if someone steals your data, you have to complain and then there will be an investigation. But, in the 21st Century, you may never know if your data has been stolen or misused.

Panel discussion

Commenting on online voting, Professor Zetzsche observed that certain institutional investors participate online, but not in large numbers. Most votes are not cast online for two reasons, he said. The first reason is that it's very boring to spend several hours in front of a computer screen in order to follow a meeting online. The second reason is that international investors can be subject to "procedural nationalism" so they hire agents to sit in the meeting in order to respond to what goes on rather than participate themselves.

One questioner from the floor asked whether the EU would make more use of XBRL to facilitate greater comparison between companies. Harding said that the Financial Reporting Lab had raised the issue of XBRL as part of its digital project. She observed that neither companies nor investors are calling for it at present, but said that there was an "inevitability" about the coming of XBRL.

Identification of shareholders is key to enabling a digitalized world, Haan noted. She said that EuropeanIssuers had been pushing for an effective means of shareholder identification at European level.

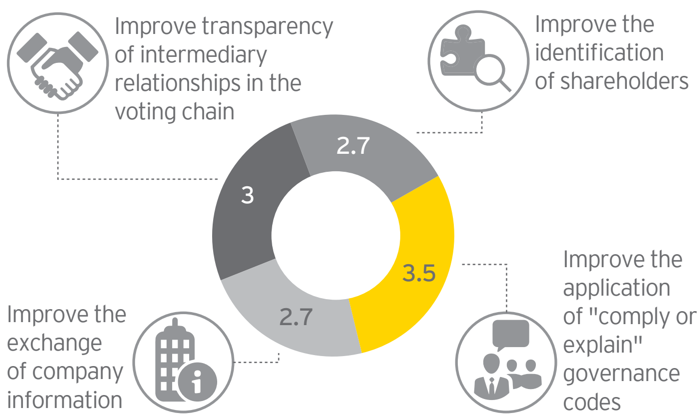
Hooijer pointed out that cyber security and data protection are important issues and people expect the systems that they use to be super safe. "We have to reconcile different public policy objectives, for example, good corporate governance, with data protection," he said. "In Europe, we have to learn lessons from countries such as Latvia and Estonia, which have developed these systems, and made them secure, and share best practice."

He also highlighted the role of social media on corporate governance, saying that it can influence decision making in a company. The European Commission is therefore exploring what social media will mean for corporate governance in the future.

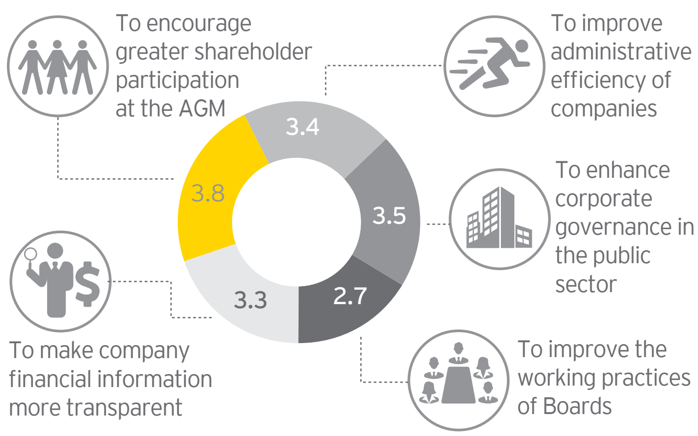
One audience participant highlighted another obstacle to the digitalized world: company law is not fully harmonized in Europe and will not be fully harmonized in the near future. Paidere pointed out that business wants to take advantage of the single market and do business cross-border. In this respect it would be useful to have harmonized rules. The Commission's proposal for a directive on single member companies (SUP) is a real step towards harmonization. But let's see the outcome of ongoing discussions. This is important not only for the EU single market and digital strategy, but it is also about EU competitiveness in the global context.

Audience poll*

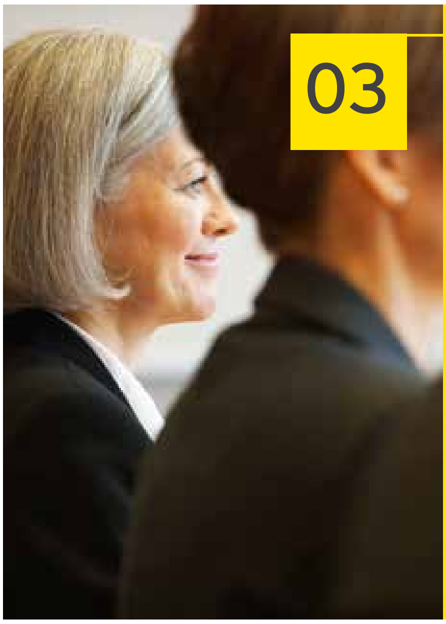
Q3. How important are each of the following in promoting digitalization across the EU?



Q4. How beneficial could further "digitalization" be in each of the following areas:



*Polling for Q3 was done on a scale of 1-6 where 1 = not very important and 6 = very important. Polling for Q4 was done on a scale of 1-6 where 1 = not very beneficial and 6 = very beneficial



03

The shareholder dimension

In this discussion, panelists addressed the issue of how institutional shareholders can influence the agenda of corporate governance as a tool for competitiveness.

> "We spend a substantial amount of time building relationships with the companies that we invest in on our clients' behalf."
>
> **Amra Balic**
>
> Head of Corporate Governance and Responsible Investment, BlackRock EMEA

> "What we don't like is getting involved in shotgun weddings where the situation is presented to us as a fait accompli."
>
> **Guy Jubb**
>
> Global Head of Governance & Stewardship, Standard Life Investments

David Devlin, Chairman of the European Corporate Governance Institute (ECGI), which supports academic research into corporate governance, moderated a lively discussion on the role of shareholders, particularly institutional shareholders, in promoting good corporate governance.

Baltic capital markets

Ivars Bergmanis, Head of Institutional Markets at Estonian bank AS LHV Pank, Research Division, said that institutional investors are the main drivers of capital markets internationally although they are inclined to be passive. Yet the Baltic capital markets are different because they tend to be dominated by strategic shareholders rather than institutional investors. Also, they also have very low market capitalization-to-GDP ratios, which is different from the rest of Europe.

Furthermore, the Baltics don't sit within a developed European index framework and they are not even regarded as emerging markets. Instead they are seen as frontier markets. There is a risk, then, that they see larger companies in emerging markets apparently doing well despite having unsuitable corporate governance so they don't then pursue good corporate governance themselves.

Bergmanis said it is important that corporate governance is marketed to strategic investors in the Baltics using a "carrot" rather than a "stick" approach or else companies will not change. Instead they will remain small and closed, which impacts on the broader economy. He called for companies that are dominated by strategic investors to find out more about institutional investors.

The "ideal" shareholder

Francesco Chiappetta, Senior Advisor at Italian tyre company Pirelli & C. S.p.A, and Chairman of BusinessEurope's Company Law Working Group, addressed the issue of whether there is an "ideal" shareholder. He said that institutional shareholders are not a homogenous class. They have different perspectives depending on whether they are an investment fund, a pension fund or an insurance company.

He said it was important to address the issue of whether the right board is in place to pursue the continued growth of the company. Furthermore, given that the board is the best actor to pursue the interests of the company and to solve any corporate governance problems that exist, it does not make sense to weaken the role of the board. Indeed, independent directors are a proven solution for ensuring that the actions of the boards are fair.

Chiappetta emphasized that there is not a single corporate governance model that functions perfectly at EU level. For example, the solutions that work for financial companies are not the best solutions for nonfinancial companies and the UK corporate governance system would not necessarily work well in other countries.

Shareholder views on corporate governance

Guy Jubb, Global Head of Governance & Stewardship at Standard Life Investments, discussed the extent to which shareholders care about corporate governance. He pointed out that a "stewardship chain" exists whereby European savers provide institutional companies with capital to invest on their behalf in companies that will be successful in the long term. "In doing so, they will set expectations and hold us to account on how we care for and interact with the companies in which we invest their funds," he explained.

He added: "We care very much for the long-term success of the companies in which we invest because our success as investment managers relies on their success and our clients' prosperity is equally aligned with that."

Jubb said that he views Standard Life as being in a "long-term relationship" with the companies in which it invests. It is also a two-way relationship. "It is important that we as investors have a very clear understanding of where the rights and boundaries of shareholders begin and end, and when the rights and responsibilities of the board of directors begin and end."

Exploring whether institutional investors can care equally for all their investors, Jubb revealed that Standard Life spends more time with companies where there are greater governance risks or where more of its money is weighted.

Jubb said that strategic shareholders in Baltic companies should invest time in building relationships with institutional investors through roadshows. Then, when they need capital, investors will invest in them because they have confidence that they know who they are backing and that they can trust the board of directors. Long-term relationships have to start somewhere, Judd said. "What we don't like is getting involved in shotgun weddings where the situation is presented to us as a fait accompli."

BlackRock's approach

Amra Balic, Head of Corporate Governance & Responsible Investment at BlackRock EMEA, outlined how BlackRock approaches corporate governance.

BlackRock is the largest investment manager in the world, with $4.6 trillion in assets under management at the end of the first quarter of 2015. Just over half of this sum is invested in global equities, mostly through index strategies.

Corporate governance is incredibly important to BlackRock, Balic stated. "We are a fiduciary asset manager, which means that what we do needs to be in the best interests of our clients. Corporate governance is a tool for delivering on that fiduciary duty. We spend a substantial amount of time building relationships with the companies that we invest in on our clients' behalf."

She said that BlackRock's starting point is to be supportive of management and to understand the board's perspective. She said that there seems to be a "strange" view in the UK that an investor is only a good steward of its client's money if it votes against the board in general meetings.

BlackRock engages with approximately 1,400 – 1,500 companies every year, and votes in about 15,000 meetings. It's wrong to assume that all companies will have problems all the time, she observed, so BlackRock focuses its engagement on companies where it can exert influence and work with the management to effect the necessary change. She said that companies are often unaware of the views that investors have on topics such as related parties and directors' remuneration. As a result, education is part of building relationships with investors.

Panel discussion

In the panel discussion, Chiappetta observed that related party transactions are an area where companies face a clear trade-off between efficiency and fairness, so they must try to find a balance between these two important needs. He said that independent directors have a key role to play in terms of related party transactions. At Pirelli, a specific committee made up of independent directors, approves related party transactions.

Chiappetta cautioned against banning related party transactions outright because they can be positive for the company. Instead he argued that member states need to be able to decide their own approaches to related party transactions, provided they have tools that enable them to avoid "tunneling" (where a majority shareholder or member of senior management directs company assets or future business to themselves for personal gain).

Jubb said that institutional investors are concerned about related party transactions where they allow the enabled parties to tunnel into the entity and divert assets in a way that is not in the best interests of the company or its shareholders.

In the UK, there is a degree of voting and scrutiny around related party transactions. Judd noted, however, that voting by shareholders was a "rather blunt instrument" since, in the case of related party transactions, friends and associates of the related party are often among the shareholders.

Interestingly, India and some other jurisdictions have the "majority of the minority." In other words, the minority shareholders who are not subject to the related party can vote on the transaction.

Jubb added that the UK has a very alert media that will often flush out those related party transactions that don't stand up to scrutiny.

The panel then debated another Shareholders Rights Directive proposal – giving enhanced benefits such as loyalty shares and dividends to so-called "long-term" shareholders.

Balic said that, as a large institutional investor, BlackRock's preference is for "one share, one vote, one dividend". Double voting rights can have unintended consequences, she observed. Companies that have a major shareholder who feels that they can ignore the views of other investors do just that – they ignore views of other investors. The result is that investors stop trying to engage with these companies and the companies no longer attract investment.

Devlin highlighted that Mark Zuckerberg, the CEO of Facebook, has a 15% economic interest in the company and 57% voting control. Fellow internet giants Google and Alibaba also have serious control-enhancing mechanisms in place, which did not stop their IPOs from being runaway successes.

Asked to give advice on how companies should facilitate engagement with shareholders, Jubb said that companies should have shareholder relations programs as well as investor relations programs. Shareholder relations programs would focus on the broader aspects of corporate governance and engagement while enabling two-way communication between companies and investors.

Balic commented that companies should look at their shareholder registers very carefully and identify those shareholders who are interested in building relationships and having an engagement dialogue on a long-term basis. These are typically the shareholders whom companies will want to use as a sounding board.

What makes you invest?

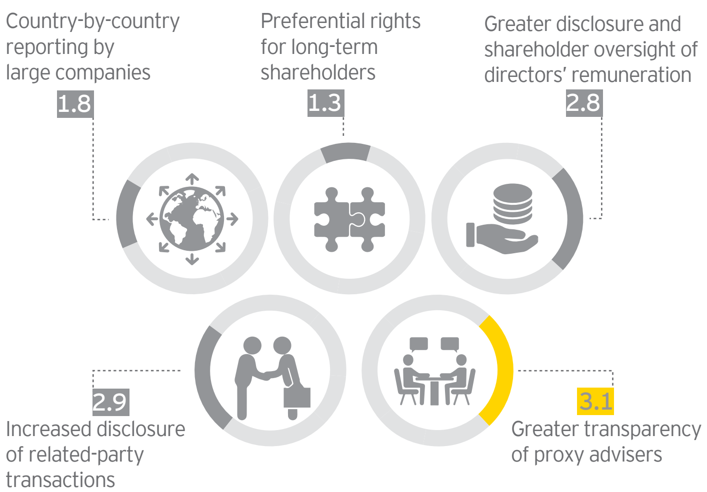
A participant from the audience asked what are the three most important aspects of corporate governance that panelists would like to see present in a company before they invest.

The answers cited by panelists included:

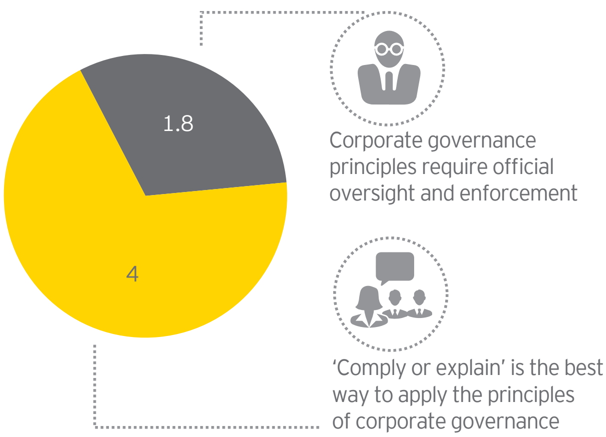
- Effective control mechanisms to manage risk
- A high-quality board that can effectively set and assess strategy
- A remuneration system that aligns the interests of management with shareholders
- Visibility and transparency
- Protection of shareholder rights
- Equal treatment of shareholders
- Evidence that the directors and non-executive directors hold significant shareholdings in the company
- Benchmarking of executive remuneration against other companies of a similar size in similar sectors
- The makeup of the other shareholders– are they institutional investors or related parties?
- The content of the chairman's statement in the annual report. In the words of Jubb: "The ones that are written in the first person singular and are written from the heart are the companies that perhaps deserve more positive consideration."
- Diversity – both gender diversity and broader demographic diversity.
- Enhanced auditor reports, which already exist in Europe and will soon be implemented across Europe. Jubb said: "For me, they have become a very good read and give very useful insights, both tonal and otherwise, as to what is going on underneath the surface."

Audience poll*

Q5. To what extent do you support the following concepts?



Q6. To what extent do you support each of the following statements:



*Polling for was done on a scale of 1-6 where 1 = not a great extent and 6 = a great extent

One size does not fit all

In a keynote speech, Laila Medin, Deputy State Secretary on law policy at the Ministry of Justice of Latvia, highlighted the diversity of Europe's shareholder base. The idea that all shareholders react in the same way is misleading and needs to be challenged, she stated. In fact, different shareholders have different characteristics, so it is not appropriate to take a one-size-fits-all approach to shareholder engagement.

She identified two main groups of shareholders:

a. Shareholder-owners

These are the economic owners of the company and they are active shareholders who see the right to vote as very important. They view general meetings as a place to discuss issues with the board.

b. Shareholder-investors

This group sees the company as a pool of assets whose main function is to provide shareholder returns. These shareholders are providers of capital and are seen as more passive than shareholder-owners. They evaluate the costs and benefits of their participation so all means of participation must be rational and cost-efficient for them. If a board performs badly, these shareholders would rather exit the company than monitor the board.

The proposals for the revised Shareholders Rights Directive take into account the different types of shareholders that exist.

Turning to the remuneration of board members, Medin said that the proposals grant the right for shareholders to vote on the remuneration of board members at the general meeting.

Furthermore, under the proposals, material related party transactions would have to be submitted for approval by shareholders or the administrative and supervisory board of the company.

- Medin concluded by saying that shareholder engagement and participation is not something that should be promoted at any cost: quality of engagement is important because this will determine if it is beneficial or damaging for the company's long-term interests.

04 The role of the board

The relationship between a company's board of directors and its audit committee was debated in this panel discussion.

> "There's a risk that you get two separate teams in the board: an A team and a B team. The A team are those board members who are also members of the audit committee."
>
> **Lars-Erik Forsgårdh**
>
> Chairman of the European Confederation of Directors' Associations (ecoDa)

> "How, as a board, do we help to create value and do we have the right composition around the table to support that value proposition?"
>
> **Guylaine Saucier**
>
> Audit Committee Chair, Wendel

Moderator Chris Hodge, Executive Director of Strategy at the Financial Reporting Council, set out the key themes for the panel to discuss in this session. These included: acquiring and demonstrating board professionalism; the composition of the board, and the role of the audit committee, including the implications of the new requirements introduced as a result of the Audit Directive and Regulation agreed in 2014.

Principal tasks

Lars-Erik Forsgårdh, Chairman of the European Confederation of Directors' Associations (ecoDa), said that promoting board professionalism is an important way of improving the competitiveness of European companies.

The demand for directors with excellent personal qualities, as well as a high level of experience and expertise is constantly increasing, Forsgårdh observed. Boards need to adapt their knowledge continually to respond to the increasing demands and expectations of the society that surrounds them.

He noted that the board selection process plays a fundamental role in board effectiveness and professionalism, while the chair has a core, strategic role. Independent directors with courage and integrity can bring further effectiveness and objectivity to the board discussions and diversity in its broadest sense also complements the board's knowledge base.

Forsgårdh added that boards' professionalism can also be improved by induction programs, board evaluation and individual director assessments – provided they are performed in a proper way.

The principle tasks of the board of directors should include:

a. Establishing overall goals and a sustainable long-term strategy
b. Appointing, evaluating, remunerating and – if necessary – dismissing the CEO
c. Ensuring that there is an effective system for control of the company's operations and risk management
d. Ensuring that there is a satisfactory process for monitoring the company's compliance with laws and regulations that are relevant to its operations
e. Defining the necessary guidelines to govern the company's ethical conduct and sustainability matters
f. Ensuring that the company's external communications are characterized by openness and that they are accurate, reliable, timely and relevant

Credibility and legitimacy

Guylaine Saucier, Audit Committee Chair at French investment company Wendel, observed that the board processes that have been put in place to secure better board members are working well. She said that the boards on which she sits in Canada and France have become much more professional over the past few years. She has chaired some nominating committees that were very disciplined about seeking out board members with the right kinds of expertise.

Saucier said that her main concern is that board members are losing credibility and legitimacy. Shareholders and regulators are saying that board members are not doing a good job while activists are criticizing them for not challenging enough. Board members need to have expertise and the courage to challenge board members, Saucier said. They also need to have time to prepare for the meetings and to be able to get information from sources other than management so that they can come to board meetings with enough information to raise issues with management in a constructive way.

Relations between shareholders and the board

Aldo Cardoso, Board Member at three companies and Senior Advisor at Deutsche Bank, said that boards need members who are willing to stand up and disagree. These people are likely to be experienced people who have a lot of their career behind them because they don't fear the implications of disagreement, he noted.

Auke de Bos, Professor at the Erasmus Universiteit Rotterdam and an EY Partner, revealed that the university conducts an annual survey of non -executive directors in order to identify trends in supervision. Through its research, it has identified three main trends:

- Supervisory board members are becoming more professional and more diverse. They are also better trained and they evaluate themselves.
- The number of tasks undertaken by board members has increased enormously, so board members need more time to perform their jobs.
- Personal liability is becoming more important to board directors. If things go right, they don't get praise, but if things go wrong, they are criticized.

Based on these trends, De Bos said that it was important that supervisory board members ask themselves: Am I the right person for this board? Do I have enough time? And do I have enough courage?

State-owned enterprises

Gatis Kokins, Chairman of the Supervisory Council of Latvian telecommunications company Lattelecom, which is majority-owned by the Latvian state, gave an example of board best practice. He said that all communication material and documentation for the Supervisory Council's meetings are distributed through a bespoke internet portal.

He argued that the state could help to maintain professionalism and quality in state-owned companies by:

- Setting up a professional and independent selection mechanism for candidates
- Defining clear and prudent criteria for candidates, paying due attention to characteristics such as the company's sector, size, market and financial condition
- Defining the competence, authority, responsibility and accountability of the board and its members, and ensuring that their performance is measured properly
- Giving suitable training to directors

In Latvia, the law regards state-nominated board members as state officials and places strict limitations on them as a result. For example, it is hard for them to combine their position with any other business employment. This deters experienced professionals from serving on the supervisory boards of state-owned companies.

Kokins argued, therefore, that unreasonable restrictions on supervisory board members should be removed and a proper mechanism of performance reporting must be developed.

Saucier, who has previously chaired state-owned enterprises, said that governments often deny the boards of state-owned companies the most important tools. For example, if the government appoints the CEO and sets the remuneration for the post, the board cannot have the same accountability as it would in a private corporation.

Audit committees

It is very difficult to constitute an audit committee, Cardoso observed. This is because it is necessary to find people who both understand the company and the technical matters that the audit committee must consider. They need to be able to talk to financial experts including the CFO, actuaries and bankers. They also need to have a sound financial education and time to invest in the job. Large companies may have as many as 12 audit committee meetings per year, which can last four to six hours per time, and there is additional preparation time upfront.

It's even harder to pick the right audit chair. The audit chair is responsible for setting the agenda for the audit committee meetings, which is very difficult. They have to decide what should be discussed, how much time should be devoted to the discussion, what kind of preparation needs to take place, who should present and what kind of reporting to the board should take place.

Commenting on how the board ensures that it has appropriate oversight of the audit committee, Forsgårdh said that it is up to the board to decide which board members should be on the audit committee. He added: "There's a risk that you get two separate teams in the board: an A team and a B team. The A team are those board members who are also members of the audit committee."

One way to even out the information gap, he suggested, would be for the audit committee to provide regular reports to the board.

Kokins observed that audit committee members becoming "privileged" board members is a real issue. At Lattelecom, the audit committee always reports to the board after a meeting has taken place to level out information asymmetry. Besides the audit committee, the company also has remuneration and business planning committees. The business planning committee, in particular, also gives good insight to board members.

De Bos observed that because audit committees are so successful, they are being given more tasks and their responsibility is increasing. For example, the issues of IT and cybersecurity are often given to audit committees. He suggested that perhaps audit committee should push back and refuse to take responsibility for these issues.

Cardoso said that he wanted to see one board that has responsibility for all matters. Putting more emphasis on the responsibilities of the audit committee is a mistake, he argued, because it will encourage all non-audit committee members to spend less and less time on financial matters and to believe that this will be taken care of by the audit committee members. Furthermore, audit committee members will be more responsible, more at risk, and more at fault if something goes wrong with the company than other board members.

Regulatory inspection of audit committees

Hodge emphasized that the EU Audit Directive and Regulation that was introduced in 2014 allocated specific legal responsibilities to the audit committee rather than the entire board for the first time. These mainly relate to the appointment process for the statutory auditor and also to the oversight of the internal control and risk management provisions within the company.

Many people are unaware, however, that tucked away in the details of the Audit Regulation, where it talks about the responsibilities of competent authorities (the regulatory bodies responsible for overseeing the regulation of the audit profession in each country), there is a requirement for those authorities to produce a report on the performance of audit committees at least every three years.

This appears to have taken the level of regulatory scrutiny of board committees to a new level, Hodge noted.

De Bos observed that the Netherlands Authority for the Financial Markets recently sent out questionnaires to audit committee members of listed companies asking questions about their roles and responsibilities. Following this, it made five observations that could form the future criteria for evaluating audit committees:

- An audit committee must realize that if there is no internal audit department within the company, the responsibility of the audit committee increases.
- The audit committee played an important role in the selection of the external auditor and this is likely to continue in future.
- Not all audit committees were aware of audit quality inspections and the outcomes of those. So they were advised to become aware of the outcome of inspections and take those into account when evaluating their external auditor.
- The audit committee should consist of members who are skilled and trained, and familiar with accounting, auditing and IT.
- Supervisory directors who take a role on an audit committee must be very critical during the process of accepting the position.

Forsgårdh said that the requirement within the Audit Directive and Regulation to report on the performance of audit committees had come as a surprise to many. He stated it that it should be the job of the board to check that the audit committee performs well, not the job of competent authorities.

Cardoso observed that as every audit committee has a different agenda, it is difficult to make comparisons between them. It would be impossible for an outside agency to come in and assess whether they are doing a good job, he claimed.

Final observations

Summing up, Forsgårdh said that it's very important that the audit committee is not allowed to become a separate, independent body. It should remain a sub-committee of the board, he said, otherwise the accountability of the board will be diluted.

De Bos observed that regulation exists so it does not make sense to fight against it, but what must not happen is that oversight becomes a compliance exercise.

Kokins commented that the size of the economy and the size of the company need to be taken into account when discussing supervisory boards – along with to what extent companies in a country are listed on stock exchanges. "What is good for the UK is not valid for Latvia and vice versa."

Saucier said that every company should aim to create value for its shareholders. Therefore, for her, the most important issue is: "How, as a board, do we help to create value and do we have the right composition around the table to support that value proposition?"

Cardoso highlighted that the more time boards spend on regulatory and compliance issues, the less time they are spending on much more important matters, such as setting the strategy and vision, and directing the company.

Audience poll*

Q1. What do you believe are the biggest challenges facing company Boards today?

*Polling for was done on a scale of 1-6 where 1 = not big and 6 = very big

Key recommendations

Latvia has three main priorities for its EU Presidency and these all underpinned the key recommendations that came out of the 16th European Corporate Governance Conference.

The three priorities are:

- A competitive EU
- A digital EU
- An engaged EU

Since well-run companies attract foreign direct investment, it is in the interests of EU member states to encourage their companies to improve their corporate governance practices – not just within the private sector, but also within state-owned enterprises and the institutional investor sector.

It was clear from the conference, however, that the EU still needs to strike the right balance between using hard law and "softer" principles in order to promote corporate governance as a competitive tool. In particular, it needs to focus on the following areas:

- Flexibility versus harmonization
- Rules versus principles
- Efficiency versus fairness
- Scrutiny versus interference

The conference produced a number of recommendations that can help to achieve this balance and these therefore merit the consideration of policymakers:

- Make greater use of principles rather than binding legislation as a way to promote good corporate governance
- Exploit digital technology to enable companies to identify their shareholders and to promote shareholder engagement
- Promote electronic voting as the default voting option
- Ensure that the digital systems in use within the investment community are secure and user-friendly
- Review the unintended consequences of trying to incentivize long-term investments
- Understand that not all related party transactions are bad and it is important to achieve a balance between efficiency and fairness when monitoring them
- Achieve a broad understanding of what "comply or explain" means and set a common standard for how much deviation can and should be expected
- Review the level of scrutiny on boards and on audit committees, in particular. Examine the implications of the three-yearly performance reporting on audit committees and what that means for corporate governance in its broadest sense. How can the performance of an audit committee be realistically measured and what is the benchmark?

Now is the time to take stock and reconsider whether existing regulation is working and whether more regulation is actually what is needed to make boards and audit committees do the jobs that they are supposed to do. The audience polls at the conference and the recommendations above point towards principles as a simpler, cheaper and more effective solution than regulation.

Given the clear faith that exists in the efficacy of principles, perhaps the regulatory pendulum needs to start swinging back the other way.

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