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Comments on the European Commission's Green Paper on corporate governance in financial institutions and remuneration policies

The Swedish Corporate Governance Board ("SCGB") has been invited to comment on the European Commission's Green Paper COM(2010) 284. Since the mandate of the SCGB only encompasses part of the range of financial institutions covered by the Green Paper, i.e. those listed on a regulated market, the SCGB will limit its response a few overall remarks concerning the regulation of corporate governance in general and to commenting upon some specific issues of relevance also outside the financial services sector. The SCGB intends to come back with more elaborate comments on the forthcoming Green Paper on corporate governance in listed companies in general, announced by the Commission.

General remarks

Better regulation requires better knowledge

With the height of the financial crisis only a few years away and its aftermath still affecting the markets it is difficult, at this point in time, to have an objective and empirically well-founded picture of the role of corporate governance in the outbreak and development of the crisis. Hence, although referring to an impressive number of study reports, conference proceedings and other sources, the Green Paper is largely dependent upon more or less subjective judgements, expert opinions and anecdotal evidence as a basis for its analysis. In particular the SCGB fails to find any attempts of systematic comparison of governance practices in the many financial institutions, in Europe and elsewhere, which were able to endure the crisis without getting into serious trouble with those that either contributed to the outbreak of the crisis or were severely damaged by it.

The SCGB also questions the immediate urgency of substantially expanding corporate governance regulation in the European financial sector. As outlined in the Green Paper, this sector will be subject to extensive new legal regulation in the years to come in the form of the European supervisory architecture, the Capital Requirements Directive, the Solvency II Directive and other measures aimed at strengthening the financial system. It is not obvious to the SCGB that an immediate and far-reaching extension of corporate governance regulation, based at this point on rather weak empirical grounds, is the best way to secure sound long-term governance standards in the European financial sector. Instead the SCGB would consider it advisable to wait with a more thorough revision of the corporate governance regulatory framework until a better understanding of the role of various governance practices in the outbreak and progression of the crisis has been obtained. The European Commission could be positively instrumental of such a development by initiating and supporting systematic research efforts, carried out in its own regime and/or by academic and other research institutions.

Binding vs. non-binding regulation

The text of the Green Paper seems to imply that all or major parts of the new regulation under consideration will be implemented in non-binding form, primarily through codes based on the *comply or explain* mechanism. The SCGB strongly supports this intention. This form of regulation is not only more flexible and easily adaptable to changing circumstances but can also, through its capability to define corporate governance standards at a higher level of ambition that what can reasonably be required in mandatory law, serve as a driving force towards continually improved corporate governance practices. This is particularly true when code regulation can be implemented through a well-developed and efficient self-regulation system, due, among other things, to the greater legitimacy among the companies affected by the regulation than what is often the case with legal regulation. The Swedish experience since the introduction of the first national corporate governance code in 2005 is a case in point in this respect. Hence the SCGB strongly favours new non-binding European corporate governance regulation to be implemented through self-regulation in Member States where well functioning such systems exist.

However, for non-binding regulation to be an efficient tool to develop corporate governance practices at the Community level it has to be interpreted and implemented in a reasonably consistent way throughout the Union. As demonstrated e.g. by the *Study on monitoring and enforcement practices on corporate governance in the Member States*, published by the Commission in November 2009, this cannot generally be said to be the case today. On the contrary, the way corporate governance codes are implemented, monitored and enforced, and how the *comply or explain* principle is interpreted and applied in practice, varies substantially between Member States. For example, whereas in some Member States companies are in principle expected to comply with all rules in the code, in others it is considered perfectly acceptable to choose other solutions so long as this is openly disclosed and explained to the market.

This situation is unfortunate because it leads to uncertainty as to which regulatory provisions may be implemented through codes and which should rather be included in law or other binding regulation. The SCGB considers it important that provisions given in codes under the *comply or explain* regime are truly non-mandatory. Provisions for which this is not considered acceptable, i.e. provisions that are to be complied with by all companies at all times, should rather be implemented in mandatory form. It would be desirable to have a clearer and more uniform comprehension of this distinction among the EU Member States.

Taking different corporate governance systems duly into account

The analysis presented in the Green Paper, and the questions for consideration derived from it, appear to rely mainly upon experiences from the British/American one-tier board system and, to a more limited extent, the two-tier system predominantly used in Germany and some other European Continental countries, without much account of the fact that there are other systems among the EU Member States which differ from both these models in significant respects. This is reflected e.g. in the text of footnote 12 in the Commission Staff Working Documented where, after a brief explanation of the two main systems, it is bluntly stated that “in some Member States either structure [referring to the two main systems] or a mix of them is possible”.

The SCGB finds it essential to draw the Commission’s attention to the fact that the Swedish corporate governance system, as is basically the case also for the Nordic region as a whole, is neither a mix of the two main systems nor falls into either of these categories. Rather, although used in only a few minor Member States, it should be viewed as a distinctly different corporate governance model and taken duly into account in the development of common European corporate governance regulation. A few examples of important distinctive features of this system are the following:[1]

– Strong shareholder powers through General Meetings allowing any shareholder to have any relevant item included in the agenda and file counterproposals to proposed resolutions and being sovereign to decide on virtually any matter it considers relevant to the company, including dismissing the board at no notice and without stated cause.

– A tradition of active involvement of major shareholders, including many institutional investors, in the governance of the company, e.g. by taking active part in the work of nomination committees and accepting seats on company boards.

– A unitary board structure with boards made up entirely or predominantly by non-executive directors, including legal prohibition of combining the positions of Chairman and CEO, hence obtaining a more clear-cut division of duties and responsibilities between the board and company management than what is invariably the case in other governance systems.

– A single-person chief executive function, fully subordinate to the Board but with far-reaching authority within these limits to carry out the day-to-day management of the company, including hiring and firing and determining employment conditions for senior management as well as other company staff.

– Statutory auditors appointed by and reporting to the shareholders at the AGM and with the mandate to review the work of the company management as well as the board.

These and other specific features of the Swedish/Nordic system lead to other priorities on several accounts in order to foster good corporate governance than in other jurisdictions. For example, there is less ground for prescribing certain issues to be "delegated upwards" from the board to the General Meeting than in some other jurisdictions. The reason is that, with or without such regulatory prescriptions, a Swedish GM always has the right to take up and decide on any matter it sees fit, and any shareholder, holding down to a single share, can have any item within the decision competence of the GM included in the agenda. In fact, requiring matters that are normally within the decision competence of the board to be subject to GM resolution (e.g. "Say on Pay") may even be contradictory to good governance practice. The reason is that the matters in question will then be subject to normal shareholder majority ruling at the GM, thus involving the risk of abuse of majority powers, whereas a Swedish board is strictly bound by law to take the interests of all shareholders duly into account in all decision-making.

Another example is the specific Swedish type of nomination committee, used by virtually all companies listed on a regulated market as well as by many non-listed companies. Rather than a board subcommittee, as in other EU Member States, the Swedish nomination committee is a separate body appointed by the shareholders at the AGM and predominantly manned by shareholder representatives. Since its emergence during the 1990's and final codification in the Swedish Code of Corporate Governance in 2005, this model has not only significantly improved the quality of board nomination procedures but also led to a more active and systematic involvement by institutional investors in the composition of boards in Swedish listed companies.[2] As will be pointed out in the next subsection, this has important implications

[1] For a summary overview of the Swedish corporate governance model, see Section II of the Swedish Corporate Governance Code booklet, and for a review of the main distinctive features of Nordic corporate governance, see the report *Corporate Governance in the Nordic Countries*, both to be found on the SCGB website: www.corporategovernanceboard.se .

[2] For a review of this model in a British corporate governance perspective, see "Tomorrow's Corporate Governance – Bridging the UK engagement gap through Swedish-style nomination committees". Report from Tomorrow's Company, London, March 2010: www.tomorrowscorporategovernance.com .

for the extent to which the composition of company boards needs to be prescribed by outside regulators.

A third example is the concept of compulsory board committees, e.g. as mentioned in Specific question 1.6. Because of the non-executive composition of Swedish boards there is little purpose, from an integrity point of view of the board vis-à-vis the company management, to refer certain matters to a subcommittee within the board. Furthermore, a Swedish board subcommittee can only deal with matters within the decision competence of the board itself, and the entire board will be responsible for any decisions made by the committee. Hence Swedish board committees are normally only given preparatory tasks, whereas all important decisions within a committee's terms of reference are to be decided or approved by the board as a whole. For these reasons, setting up board subcommittees for dealing with certain matters within the board's scope of responsibilities is in the Swedish system primarily a matter of efficient organisation of the Board's work, a question that the SCGB believes is best left to the individual board to decide.

The SCGB considers that these and other specific features of the Swedish/Nordic corporate governance system should be given due consideration in any forthcoming regulatory action from the European Commission.

Comments on some specific issues

Regulating board composition

The composition, role and functioning of the board of directors belong to the most crucial aspects of corporate governance. Hence it is well motivated that considerations about these matters are devoted much attention in the Green Paper. However, in particular regarding the recruitment and appointment of board directors, the analysis and questions for consideration presented seem to reflect a more far-reaching regulatory ambition that what the SCGB generally considers appropriate.

In the view of the SCGB there is a basic choice between two alternative courses of action in this respect: One is to prescribe, more or less in detail, the size, competence structure, degree of diversity along various lines, etc. of the board. The other is to basically leave to the shareholders, within limits acceptable to the society, to appoint board members. Whereas the Green Paper seems to lean mainly towards the first option, the SCGB in principle favours the second.

There are two main reason for the SCGB's standpoint on this matter: The first is the basic belief that it is an integral part of the ownership rights to choose the people who are to manage the owners' collectively owned asset. The second is that no other party than the owners can be expected to take a strong responsibility for the company, and that the appointment of the board is the prime measure available to the owners to fulfil this responsibility. For each step we move away from these principles, the accountability of the owners will be weakened. If such a development is allowed to proceed too far we may run the risk to end up in a situation where no shareholders of listed companies are prepared to assume the role as real, long-term owners rather than as more or less short-term investors.

However, for shareholders to find it worthwhile to assume real ownership responsibilities they must feel that they have real powers to influence the recruitment and appointment of board members. If this is not the case to a reasonable extent, which appears to be doubtful in some jurisdictions within the EU, shareholders will have weak incentives to get involved in the choice of board members. In the view of the SCGB the remedy action in such situations should not, however, be to regulate in detail "from outside" how boards are to be composed, but rather to strengthen the powers and incentives of shareholders to get involved in and influence the selection of board members. Measures to this end could include strengthening the powers of the General Meeting to determine the composition of the board and to encourage shareholders to get involved in the nomination of candidates for board positions. Swedish-style nomination committees, as referred to above, have proven highly instrumental in this respect

Risk-related functions

Under this heading the Green Paper discusses some regulatory options aimed at strengthening the risk management function of companies, including rules for the communication between such a function and the board, and to require a "chief risk officer" function to report directly to the board. Both these are examples of provisions that would not be consistent with the Swedish corporate governance system, according to which the (one-person) CEO is the only legally defined executive function, accountable to the board (and the shareholders) regarding all aspects of the day-to-day management of the company, whereas all other members of the senior management team are subordinate to and report formally to the CEO. This does not mean, however, that the board cannot require such executives to make presentations to the board on matters within their respective areas of responsibility.

For the same reason the notion of requiring senior management to approve an evaluation report on the adequacy and functioning of the company's internal control systems is only meaningful if directed exclusively to the CEO. Even so it would not increase or in any other significant way change the legal accountability of this function. On the other hand it would inevitably lead to significantly increased administrative costs, possibly including auditing costs in order to verify the reliability of the report. Against this background the SCGB advises against the introduction of a mandatory report of this kind in Swedish corporate governance regulation.

Specific questions regarding remuneration of directors of listed companies

Since the questions under this heading, in contrast to other parts of the Green Paper, seem to apply to listed companies in general, the SCGB finds it appropriate to comment briefly on each of them:

7.1 The SCGB strongly prefers any such regulation in non-binding form under a *comply or explain* regime, except for provisions with which companies should be obliged to comply without exception (cf. comments in the section on binding vs non-binding regulation above).

7.2 In the latest review of the Swedish code, a provision saying that "remuneration of non-executive board members is not to include share options" was introduced. Still the SCGB considers that this issue should be left to individual Member States to decide and finds it even less motivated to regulate this at Community level in binding form.

7.3 Sweden probably belongs to the Member States referred to in this question. Still the SCGB does not consider this to be a problem of any magnitude warranting further regulatory action. Stock options and other form of "tax-effective" remuneration is not generally used in Sweden to an extent that threatens appropriate risk management in listed companies in general.

7.4 The answer is no, for the two reasons given in the first paragraph after the bullet points in the section on different corporate governance systems above.

7.5 The SCGB questions the view on severance pay ostensibly underlying this question, including the habit of referring to such arrangements in general as "golden parachutes". Although there have been obvious cases of abuse of such arrangements, especially in some Member States, used in a proper and well-balanced way, e.g. as provided for in Rule 9.9 of the Swedish Corporate Governance Code, severance packages are well-motivated and constructive arrangements, both from the individual's and the company's point of view. A Swedish CEO, in stark contrast to all other employees, can be dismissed with immediate effect without stated cause. Hence it is motivated to grant the individual some degree of financial security. If not this would have to be obtained through other means, most likely by substantially raising CEO fixed salaries. Furthermore, seen strictly from the point of view of the company, lack of reasonable such security for a CEO would act to decrease the integrity of the individual vis-à-vis the board and to foster overly prudent and risk-averting rather than entrepreneurial CEO behaviour.

Against this background the SCGB opposes the idea of prohibiting severance packages in general. Such packages are not to be viewed as “rewards” for either good or bad performance, as invariably seems to be done, but as mutually constructive parts of remuneration packages for top executives. Hence the concept of banning severance pay in cases of unsatisfactory performance is also inappropriate in the Swedish context, since in what probably makes up the majority of cases of CEO dismissal, in the view of the board this is precisely the reason for taking this action.

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