

European Commission 2014-2015 Corporate Governance Reforms

Overview and Implications

This is to inform you of the recent broad-ranging governance initiatives in Europe, which have taken significant steps forward in recent months. These implement key actions identified in the Commission 2012 Action Plan on European Company Law and Corporate Governance, as well as the 2014 Communication on Long-term Financing of the European Economy.

The European Commission has accordingly proposed significant reforms under the **Shareholder Rights Directive** and the **Quality of governance reporting** recommendations; the European Parliament has already approved new EU legislation regarding companies' **Statutory Audit** and **Disclosure of non-financial information**.

- Revisions to the **Shareholder Rights Directive** include changes to the disclosure obligations in respect of remuneration and the introduction of a binding vote on remuneration policy. It also imposes new disclosure obligations on proxy advisors and the requirement for shareholder approval of certain related party transactions.
- The European Commission **Recommendation on the quality of Corporate Governance reporting** enhances the 'comply or explain' principle, providing guidance to listed companies for improving the overall quality of corporate governance statements.
- The **Reform of the EU Statutory Audit** provides for new rules on non-audit services by auditors and mandatory auditor rotation, towards ensuring audit quality, transparency and independence.
- The **Directive on disclosure of non-financial and diversity information** requires large companies to increase transparency and performance on non-financial metrics, including board diversity, environmental and other relevant social matters.

The proposed new framework is a first step of the EU legislative procedure to be completed in the following months. Member States will bring into force the laws, regulations and administrative provisions necessary to comply with the new reforms after entry into force.

These reforms will affect both companies and investors, with the aim of enhancing accountability transparency and sustainability. In particular, companies need to acknowledge and prepare for adopting highest governance standards and ensure transparency of governance framework and reporting, within an ever stronger engagement with their investors.



REVISION OF THE SHAREHOLDER RIGHTS DIRECTIVE

The Shareholder Rights Directive is a major corporate governance development in its aim to improve shareholder rights and long-term sustainable investment. Investors will be encouraged to engage more with their investee companies, through taking a longer-term perspective of their investment. Companies will need to be prepared to positively and proactively engage and respond to investors.

The provisions may raise concerns for companies on a number of fronts, including compliance burden and the protection of commercial information from disclosure to the public. However, these concerns would be mitigated when provisions apply on a 'comply or explain' basis.

Key revisions are outlined below.

Identification of shareholders, transmission of information and facilitation of exercise of shareholder rights

Listed companies will be given the possibility to have their shareholders identified. Name and contact details of the shareholders will be transmitted to the company (by the intermediary in the holding chain) upon its request, for facilitating the exercise of shareholder rights. The intermediary will also transmit to the company information received from shareholders related to the exercise of rights flowing from their shares.

The intermediary will facilitate the exercise of the rights by the shareholder to participate and vote in general meetings, where the case through a nominated person, upon explicit authorization and instruction of the shareholder. The company will also have responsibilities within this framework, confirming the votes cast in general meetings by or on behalf of shareholders.

Engagement Policy of institutional investors and asset managers

Institutional investors and asset managers will develop a policy on shareholder engagement and disclose on annual basis their engagement policy, implementation and results. In case they do not adopt an engagement policy, investors will provide reasoned explanations as to why this is the case. Institutional investors and asset managers will, for each company in which they hold shares, disclose if and how they cast their vote at the general meetings of the companies concerned and provide explanations regarding their voting behavior.

Transparency of proxy advisors

Proxy advisors will adopt and implement measures to guarantee that their voting recommendations are accurate and reliable. At the same time, they will publicly disclose, on annual basis, information in relation to the preparation of their voting recommendations (methodologies, main information sources, national market, legal and regulatory condition). The information will be published on their website and remain available for at least three years. Furthermore, proxy advisors will identify and disclose to their clients and the company any actual or potential conflict of interest or business relationships that may influence their voting recommendations.

Vote on remuneration policy

Each listed company in the EU will be required to put its remuneration policy to a binding shareholder vote at least every three years. Once the remuneration policy has been approved by the shareholders, a company will not be



permitted to pay remuneration to directors other than in accordance with that approved policy. Shareholders will also have the right to vote on a company's remuneration report, which describes how the remuneration policy has been applied in the last year, such vote being advisory-only. Where the shareholders vote against the remuneration report, the company shall explain in the next remuneration report how the vote of the shareholder has been taken in account.

Remuneration policy and Remuneration report

Companies will have to provide a clear, understandable remuneration policy, in line with the business strategy, objectives, values and long-term interests of the company and incorporate measures to avoid conflicts of interest. The policy will set clear criteria for the award of fixed and variable remuneration, indicate the maximum amounts of total remuneration that can be awarded, explain the ratio between the average remuneration of directors and the average remuneration of full time employees of the company, the main terms of the contracts of directors, the decision-making process leading to its determination. Any decision not to disclose such elements would need to be thoroughly explained.

The remuneration report will also need to be clear and understandable, including explanations on the link between the total remuneration and long-term performance, the relative change of the remuneration of directors over the last three financial years and mechanisms adopted to reclaim pay.

Related Party Transactions

Transactions with related parties representing more than 5% of companies' assets or transactions which can have a significant impact on profits or turnover will be submitted to a vote by shareholders in general meetings. For smaller related party transactions, representing more than 1% of their assets, listed companies will have to publicly announce such transactions at the time of conclusion, and accompany the announcement by a report from an independent third party assessment.

Once adopted by European Parliament and Council in the upcoming months, the new Directive would have to be implemented into the laws of all EU Member States.

RECOMMENDATION ON THE QUALITY OF CORPORATE GOVERNANCE REPORTING

The European Commission issued a recommendation on corporate governance reporting, providing guidance to listed companies for improving the overall quality of corporate governance statements. Companies will therefore find themselves more challenged to provide information in a perfectly transparent manner. Meantime, expanding use of the 'comply or explain' approach will bring directors into dialogue with shareholders on a wide range of issues.

The Recommendation specifically looks to improve the quality of explanations provided by issuers in case of departure from the recommendations of the relevant corporate governance code (the 'comply or explain' principle).



Companies will need to ensure the following approach to governance reporting: declare which specific recommendations they have departed from; explain in what manner the company has departed from each recommendation; describe the reason for the departure; describe how the decision to depart was taken within the company; explain when the company envisages complying with a particular recommendation; describe how any measure taken instead of compliance achieves the underlying objective of the specific recommendation or contributes to good corporate governance of the company.

The Commission has invited Member States to inform it of the measures taken in accordance with this Recommendation by spring 2015.

DIRECTIVE AMENDING THE EXISTING STATUTORY AUDIT DIRECTIVE

The European Parliament has approved the amendment of the Directive on the role of auditors, with the aim of improving audit quality across the EU and ensuring that auditors are key and concrete contributors to the economic and financial stability. Companies need to be aware of stricter requirements that will apply to their statutory audit, reducing risks of excessive familiarity, encouraging independent approach and limiting conflicts of interest.

The rule introduces stronger requirements on independence, notably by improving the organizational requirements of statutory auditors and audit firms. Companies will need to provide audit reports that are more informative for investors, providing them with relevant information about the audited company, beyond a mere standardized opinion on the financial statements.

Also notably, firms will have to put audit business up for bid every ten years, with mandatory rotation after twenty years, in most cases. Reforms also include providing the right of 5% of shareholders to propose a resolution to dismiss auditors, the strengthening of audit committees, and rules intended to improve the quality of audit and audit reporting. Non-audit services fees by the statutory auditor will be capped, while some non-audit activities such as tax advice will be prohibited. A more dynamic, better supervised audit market will also be established.

Following final approval by the European Council, publication in the Official Journal of the EU will follow in the second quarter of 2014.

DIRECTIVE ON DISCLOSURE OF NON-FINANCIAL AND DIVERSITY INFORMATION BY LARGE COMPANIES AND GROUPS

The European Parliament has approved a new law that will facilitate the disclosure of non-financial information by large companies, taking into account current best practice, international developments and related EU initiatives. Companies will accordingly be subject to more ESG (environmental, social and governance) scrutiny by the market, who expects appropriate disclosure of non-financial measures considered in the business.



Companies concerned (with more than 500 employees) will need to disclose information on policies, risks and outcomes as regards environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity in their board of directors.

As regards diversity on company boards, companies will be required to provide information on their diversity policy, such as, for instance: age, gender, educational and professional background. Disclosures will set out the objectives of the policy, how it has been implemented and the results, on a 'comply or explain' basis.

The directive gives companies significant flexibility to disclose relevant information in the way that they consider most useful, or in a separate report. However, companies will be encouraged to use standardized, recognized frameworks, such as the Global Reporting Initiative Sustainability Reporting Guidelines and the UN Guiding Principles on Business and Human Rights.

The directive will enter into force once adopted by the Council and published in the EU Official Journal.

Taken in the aggregate, the EU regulations are necessarily lengthy yet thorough, allowing for substantial dialogue and engagement of stakeholders to inform the decision-making process.

Engagement, one of the main objectives of the reforms, has the potential for positive externalities; investors should be free to determine whether they wish managers to engage on their behalf and, if so, on what basis. Yet, in promoting engagement, **Transparency** has a central role to play. It facilitates monitoring by end investors, beneficiaries, and organized civil society, thereby empowering willing parties to pave the way for further engagement. As such, it becomes a critical element of these reforms.

While monitoring regulatory developments, Sodali has constantly been promoting engagement, advising companies to be on top of the issues, perform well and explain their strategy to create shareholder value and engage proactively with investors.

Do not hesitate to contact our Corporate Advisory team for any further information or clarification on the above issues.



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