ECGS COMMENT ON THE EC RECOMMENATION ON CORPORATE GOVERNANCE "comply or explain" COMPLIANCE

August 2014

Expert Corporate Governance Service (ECGS) is a European proxy advisory company registered in London and managed in Paris as a partnership of independent local market experts which have come together to provide specialist governance research and proxy voting advice. ECGS offers institutions access to unrivalled experience on corporate governance and responsible investment issues.

The Managing Partner of ECGS is Paris based Proxinvest. Other active ECGS Partners are DSW (Düsseldorf), Ethos Services (Geneva), Shareholder Support (Rotterdam) and Frontis Governance in Rome. ECGS also employs local governance experts in London (Manifest), Montreal and Melbourne. ECGS acts solely in the interest of all shareholders and is generally free of conflicts of interests in the production and sale of its advisory services.

Along with the European Commission Recommendation ECGS considers that companies with good corporate governance are likely to be both more competitive and viable in the long term, and that governance being an intricate matter by nature cannot be only covered by binding regulations. The questions that are left to governance codes are indeed often questions for which there are several good possible answers for different companies.

Listed companies and others derive maximum benefit from the flexibility of non-binding "comply or explain" recommendations to create a consensus without creating a burden over the life of societies and without establishing new rules sometimes inadequate or inexperienced.

The Directive obligation to for listed companies to publish a statement on corporate governance in their annual report happily confirmed the general movement of European companies: they now provide rich responses to governance, internal control and risk management issues. Similarly the request but not the legal obligation for companies to comment on their compliance or exceptions seems excellent for the reasons of the above explained flexibility and the sense of responsibility, underlined by the Recommendation..

The Recommendation emphasizes the need for high quality information: it is true that the framework of the essentially optional "comply or explain" process sometimes produces stereotyped responses or non- personal statements by many companies.

ECGS which points continuously to the issuers voluntary or not voluntary breaches with best corporate governance standards or to some of their failures to provide the regulated information agrees with paragraph 19 of the Recommendation on a certain lack of

companies control / audit reports, and supports the Paragraph 20 proposal that shareholders should ensure the active control of the quality of the information.

ECGS notes that serious deficiencies happily are very rare and that a largest share of failures or omissions pretends to improve the company image. These deficiencies then act then as weak signals for shareholders, analysts and advisors.

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And proxy advisory analysts such as the associates of the ECGS network are therefore taking great care to the quality of the comments that each company can provide on any of its derogations to the reference code. Further, in extreme cases, the quality of the Chairman's special report on corporate governance and internal control, or one of the mute auditors review can be challenged by our proxy voting analysts. Some companies statements considered unfair or deceptive may even lead to a negative vote recommendations on the "discharge" or even on the financial statements, or on the re-election of the chairman of the Board or of the chairman of the relevant specialized committee. It is often the same for the vote to approve executive compensation, or Say on Pay, when the compensation disclosure does not meet the local recommendations and when the reasons given, for non-compliance are insufficient. Here again, these breaches or unsufficient comment on a non-compliance may in extreme cases trigger an advice for opposition to the renewal of the Chairman or of the chairman of the specialized Board committee . .

As an answer to these weak signals comes the no less weak signal of the negative vote of some minority investors. It is therefore clear that the control of governance must rely on shareholders as well as they will be the first to reap the benefits of a good organization and the first to suffer from poor governance. It thus belongs to the shareholders with the help of their service support companies, their independent financial analysts, their proxy advisory firms, their journalists to appreciate the quality of the company compliance to its reference code. The EC Recommendation recognizes happily that she does not know the right way to force all companies to provide good explanations, frank, sincere and complete. : Perfection is not of this world and governance is as conventional financial reporting a mere gradual improvement process.

This said, ECGS would like to attract the attention of the Commission on two important issues.

1 / the conditions for establishing the reference Governance code in some countries, like France, are not neutral. This leads to our demand that reference Governance codes for listed companies serve broader interests than only the single big issuers community, i;e. the managing directors interests.

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2 / on the other hand, the growing intervention of the local regulator in monitoring, commenting and adjusting the Governance reference code recommendations might have a dangerous side effect: we observed in France that the AMF focus on the AFEP-Medef code finally threatens compliance and enforcement of existing laws and regulations and therefore threatens market integrity. We believe that: the "compliance" to codes of recommendations should rather be left to private market actors and should not take the place of the needed control and enforcement of legal and regulatory rules.

3/ While codes of practice refer to legal mandatory rules in order to avoid confusion, we suggest that all their requirements or recommendations remain optional and that none are ever binding. The only obligation attached to this type of code is to explain the non-

application. In short, for ECGS "soft law" should always be non-compulsory while the positive “hard” law should be mandatory and should be implemented.

1 / the reference Governance codes for listed companies should be based on broader interests than the sole issuers community.

Reference codes must represent mixed interests rather than only the interests of the companies top management. It is not appropriate given the recognized market forces imbalance between the buy-side and the sell-side, that there is no recommendation on how Governance reference codes should be written insuring a balance between the different editors: issuers, investors, academics, public authorities, etc . In France AFEP MEDEF first consulted privately some representatives of investors, in 2013 including Proxinvest, but felt not obliged to take their advice into account, which is legitimate, since it also bears the name its signatory organizations. Further Proxinvest considers that, to become a recognized market reference code, the code should be written and reviewed only through the balanced cooperation between the two sides of the financial market.

2 / the control of the compliance with Governance reference codes should not threaten the control and enforcement of the rule of law.

The international development of governance codes certainly played a positive role in the evolution of companies’ behavior. We recognize that these standards of good practice, accessory to the rule of law, help avoid the cluttering the written binding regulations, these non-binding rules being capable of adjustments and applying to companies of very different seniority and size. The merit of these optional reference codes is precisely this flexibility and it is therefore up to private players to insure by themselves the monitoring of their compliance by each company. It is also desirable that in private litigation lawyer or judge be able to refer to these catalogs of optional good practices if only to put the parties behavior into perspective.

However, the intervention of the market regulator in this compliance process is not neutral and this has at least two serious shortcomings.

First, the legitimate positions taken by a market regulator on particular Governance recommendations tends to create confusion when this regulator review the companies compliance with their own set of Governance recommendations The support of one recommendation by the regulator might create confusions, and his recommendations then become some-how more binding and the compliance control process might appear biased. .

Second and more dangerous, the interest of the regulator and the time given to monitor the compliance with these kind of accessory non-binding rules may affect the enforcement of the rule of law. This might, in our opinion, create a real problem in the application of the rule of law.

In France, the 2009 Act imposes that the AMF reviews each year in a special report the application or non-application by public companies of their chosen reference code[1], generally the AFEP MEDEF or the Middlenext issuers’ codes.

[1] Article L621-18-3 : (Ordonnance n°2009-80 du 22 janvier 2009) - : Les personnes morales ayant leur siège statutaire en France et dont les titres financiers sont admis aux négociations sur un marché réglementé rendent publiques les informations requises par les sixième, septième et neuvième

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The local ECGS member, Proxinvest, considers that it is not the proper role of a market regulator to make such comments on the application of optional rules which by definition must remain free. While Proxinvest recognizes fully the authority of the AMF on these Governance issues, but the monitoring of the compliance with these soft law items, uses the regulator skills and means and weakens the needed enforcement of the rule of law, the "hard" law.

Some legal rules, possibly because of the multiplicity of competing recommendations, are not fully respected by listed companies, while the regulator becomes involved in an secondary compliance issue.

Proxy agencies observe frequent irregularities in the disclosure practice by issuers of related party transactions, the identification of shareholders, the operations of the companies on their own shares, the executive directors' remunerations. Taking as example, the information on remuneration, Proxinvest in France observed for example that the two listed banks praised in 2013 by the AMF report for their fair compliance with their reference code had both actually violated the public rule of shareholder information as to the content due to shareholders and its legal timeliness. Proxinvest also observed certain related transactions or payments to Directors concealed a few year in violation of the NRE 2001 law while the above mentioned two listed banks did not provide the CEO variable pay for the past 2012 year, violating both the law and their code of reference: should these be exempted from the application of the law because it would have made a good explanation for this non-compliance?
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For ECGS it is not therefore not desirable that the market regulator be involved in the verification and compliance with "comply or explain" recommendations as these belong to private market players, particularly shareholders and analysts, as an annual compliance report by AFEP MEDEF on his own code has recently been announced . This does not prevent the regulator to question the governance of a particular issuer, and why not, to require in the extreme cases as did the United States DOJ and the SEC for Siemens or Total that the company appoints as a "Corporate Governance Monitor approved by the regulator to promote better practice at these companies.

3/ ECGS believes that codes of practice to supplement the applicable regulatory body must not create confusion and only contain optional non mandatory recommendations: their only mandatory rule should be to comment on compliance or non-compliance with these guidelines. .
"Section 2 of the General Provisions in section 1 of the Commission Recommendation states:" It is recommended that, where appropriate, the code of corporate governance draws

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alinéas de l'article L. 225-37 du code de commerce et par les septième, huitième et dixième alinéas de l'article L. 225-68 ainsi qu'à l'article L. 226-10-1 du même code dans des conditions fixées par le règlement général de l'Autorité des marchés financiers. Celle-ci établit chaque année un rapport sur la base de ces informations et peut approuver toute recommandation qu'elle juge utile. L'Autorité des marchés financiers peut prévoir que l'obligation mentionnée au premier alinéa est également applicable, dans les conditions et selon les modalités fixées par son règlement général, aux sociétés ayant un siège statutaire en France et dont les titres financiers sont offerts au public sur un système multilatéral de négociation qui se soumet aux dispositions législatives ou réglementaires visant à protéger les investisseurs contre les opérations d'initiés, les manipulations

a clear distinction between the parts of the code that it may not be waived those applied on a "comply or explain" and those that apply on a voluntary basis. ". We consider that the merit of the chosen “comply or explain” procedure is to enable companies to deviate from best practice and keep a flexible approach to these issues: therefore, ECGS fears that introducing binding elements in a set of best practice recommendation introduces a "rigidity" that is not consistent with the objective of these codes of practice and not in line with the "comply or explain" principle.

A subdivision of the codes of practice into three categories of mandatory provisions optional but available to be commented and additionally ancillary provisions of purely free and to to be commented possible practices could create confusion for stakeholders and observers. The recommendation of a code of practices should supplement but not replace the legal rules and companies are simply encouraged to comply by their accepted obligation to explain. This does not preclude the creation of application thresholds for some of these non-binding recommendations to exempt smaller companies.

We believe therefore that the point 2 in its present form could be confusing and suggest following rephrase this point 2 as follows: "It is recommended that the code of corporate governance draws a clear distinction between legal rules which cannot be derogated from those recommended non-binding practices subject to the "comply or explain" diligence and other good practice provided by the code as an information requiring no explanation of compliance.

In conclusion, it seems to ECGS that while regulators should monitor governance and watch the implementation of codes of reference, in particular to reduce or increase when needed the regulatory requirements, the economy of the "Comply or explain” codes should remain private. It belongs to companies and their professional organizations, to shareholders and their agents to first insure a balanced setting of the local code of practice and then to check by themselves the compliance work of the members of these codes.

While not commenting on individual practice of the corporations the regulator could occasionally worry even publicly about the governance practice of the issuers. Regulators could further in extreme cases call for the appointment of a "Corporate Governance Monitor" approved by the regulator to promote better practices, as recently ordered in the United States the DOJ and the SEC from the Siemens and Total companies. However, we believe that the energy and expertise of the regulator must, in the interests of investor protection and market balance, remain exclusively serving the law and regulations. The controller can certainly have an opinion on issues of governance, but must remain on the highest level and not distribute medals or bad points on optional practices. However, when necessary, the regulator who has a direct knowledge en enforcement powers, should call the Judge or possibly fine for breaches with the legal rule and thus ensure better protection for savers within a clear and known to all regulatory framework.

August 2014