Date

31 July 2003

Le Président

Fédération des Experts Comptables Européens AISBL

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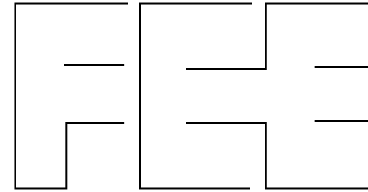


Mr Gianluigi Campogrande
Head of Unit Company Law, Corporate Governance and Financial Crime
DG Internal Market G3
European Commission
Rue de la Loi 200
B-1049 BRUSSELS

cc Mr Dominique Thienpont

E-mail: MARKT-COMPLAW@cec.eu.int

Dear Mr Campogrande,

Re: EC Communication "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward"

FEE (Fédération des Experts Comptables Européens – European Federation of Accountants) is pleased to provide comments on the Communication and related Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward (referred to below as the Communication on Company Law and Corporate Governance). We appreciate that the Commission seeks comments before finalising the Action Plan and entering into a modernisation exercise of the Company Law Directives.

The Communication on Company Law and Corporate Governance as well as the Communication on Statutory Audit are important initiatives in the context of restoring confidence in financial markets. Corporate governance arrangements need to be strengthened so that they are equally effective across the European single capital market. A well-developed company law framework is needed in order to facilitate business efficiency, foster competitiveness and contribute to economic growth and public welfare. An effective modern company law framework is a necessary condition to strengthen public confidence in the European single capital market. A modern system of company law should be sufficiently robust to accommodate the continuously changing environment of business, and it should encourage convergence across Europe, but it should not be unduly burdensome.

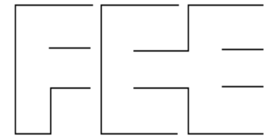
FEE welcomes the initiative of the Commission to modernise company law and to enhance corporate governance. We agree that it is the right time to give a fresh and ambitious impetus to the EU company law harmonisation process. We support the key policy objectives identified of strengthening shareholders rights and third party protection and fostering efficiency and competitiveness of business.

Our comments and input on the EU Action Plan as laid out in section 3 of the Communication are attached to this letter. We have addressed those issues where we believe our profession has relevant expertise and experience and hence a valuable contribution to make.

Our key comments include:

- The accountancy profession has a valuable contribution to make to the expert consultation on company law and corporate governance and to the European Corporate Governance Forum (see section 1.2 of the attached note of our main comments).

 Association Internationale reconnue par Arrêté Royal en date du 30 décembre 1986



- We strongly urge the Commission to reconsider its proposed priorities in Annex 1 that fall under the heading of capital maintenance. This is in respect of both the feasibility study and actions to amend current requirements. There is now less than 18 months until the proposed introduction of IAS and the issues that this will bring for financial reporting and its consequent effects on the capital markets. Action on the capital maintenance/solvency test is, we believe, a high priority short term matter and should not be left the medium and longer term as currently classified in Annex 1 to the Communication (section 2).

- FEE supports the concept of the annual corporate governance statement but its development will need to be carefully thought through (section 3.1). We also agree that there should be no European Corporate Governance Code, but only key principles and common benchmarks at the EU level with the details in the national codes (section 3.2). We also ask for clarification as to whether such a corporate governance statement should form part of the financial statements as this has to deal with related audit implications (section 3.1.2)

- We disagree with the first paragraph of page 15 of the Communication that such responsibility for nominating directors should be entrusted to a group comprised mainly of <u>executive</u> directors. Not only is this incompatible with much existing international practice, it is also contradictory to the Jaap Winter Group Report. We understand that the particular wording may represent a misunderstanding in that we have heard Commissioner Bolkestein explain that the nomination of future top management should be primarily a matter for executive directors; if so, the position should be clarified (see 4.1). In any event, we strongly recommend that the text of the Communication should be amended to read "a group comprised mainly of <u>independent non-executive directors</u>". Much of corporate governance is built upon the oversight undertaken by the independent non-executive directors on the (supervisory) board who are acting on behalf of shareholders. The consequences of the proposal on page 15 could undermine much of the progress that has been, and continues to be, made to improve corporate governance. We urge the Commission to alter the wording on page 15. Further information is provided in section 4.1.

- Independence is an important characteristic of non-executive directors and audit committee members. A principles based approach needs to be used to assess threats and safeguards to independence (see the forthcoming FEE paper on A Conceptual Approach to Independence in the Financial Reporting Chain) (section 4.2).

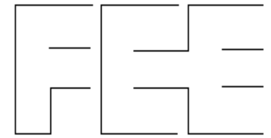
- We fully support strengthening the role of non-executive directors and supervisory directors as a short-time priority. This should include proposals on audit committees given the current discussions and developments on changing the Eighth Directive and given the importance of audit committees in the transatlantic dialogue.

We would be please to discuss any aspects of this letter you may wish to raise with us.

Yours sincerely,

David Devlin
President

<u>Encl</u>.



Main Comments to the Communication on Company Law and Corporate Governance

1. Consultation

1.1. The Communication

FEE supports the Commission's initiative for wide expert consultation on company law and corporate governance matters.

The European Commission's Communication states (section 3, page 10):

- An open, public consultation will also be organised, where appropriate in the future, on the major initiatives following from the Action Plan.

- Expert consultation should be an integral part of the preparation of initiatives at EU level in the areas of company law and corporate governance. The Commission therefore will regularly seek advice from representatives of Member States, as is the case of the current Group of Company Law National Experts, but also from representatives of the business and academic sectors, to provide the necessary external input.

- A European Corporate Governance Forum will be convened once or twice a year to contribute to coordinating corporate governance efforts of Member States.

We regret that the accountancy profession is not specifically mentioned in these consultation initiatives. We believe that accountants are important stakeholders in this area and the day to day practical experience of many of them in the accountancy profession brings a wealth of expertise that should not be ignored.

1.2. The role of FEE

From a European perspective, FEE is best placed to focus this expertise for the benefit of the proposed Forum:

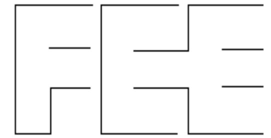
- FEE has been proactive on the major subjects over a number of years, and its role has been widely recognised by all the key players. Representing 41 professional bodies from 29 European countries, FEE prepares its initiatives with wide and skilful representation from its members.

- FEE recognises that confidence in financial reporting and in audit is a key factor in restoring and maintaining confidence in capital markets and we are taking an active role in this area. In contributing proactively to the corporate governance debate, we will shortly be publishing a discussion paper entitled "Financial Reporting and Auditing Aspects of Corporate Governance". An advance copy of the paper is enclosed with this letter.

- FEE has also actively contributed to the debate on company law issues and in particular on the consultative document issued by the Jaap Winter Group. Overall, the conclusions of the FEE corporate governance discussion paper are substantially in line with the recommendations of the Winter Group and of the Communication on Company Law and Corporate Governance.

- With our experience and knowledge, we strongly believe that our profession has a profound and practical contribution to make to the expert consultation and to the European Corporate Governance Forum.

- In a speech he gave to a special seminar we held before our General Assembly on December 19, 2002, Jaap Winter, Chairman of the High Level Group of Company Law Experts, stimulated FEE to take an active role in the field, recognising our competence and our technical preparation.



We would strongly urge the Commission to specifically include the European accountancy profession in the broad category of representatives of the business sector and market participants. If this acceptable, we ask the Commission to explicitly indicate the accountancy profession in the list of experts (paragraph 3, page10 2nd indent) as well as in the last paragraph of 3.1.4 that indicates the possible participants to the European Corporate Governance Forum.

1.3. Clarity of wording in the Action Plan

As an overall point, the use of clear and unambiguous wording and an accurate translation throughout the Action Plan is highly recommended to, at a minimum, avoid the future potential for unforeseen consequences. Whilst essentially being a matter for future when the proposals in the Action Plan are turned into detailed requirements etc., we suggest that any ambiguities are dealt with before the wording of the whole Plan is finalised. Particular examples are referred to in paragraphs 3.1.2, 4.1 and 4.5 below.

2. Capital Maintenance: reconsidering priorities

January 2005 should see the introduction of International Accounting Standards (IAS). This is now less than 18 months away and there are many critical issues to address that are likely to impact the financial results to be reported by companies. IAS will thus also affect the financial markets and issues include such vital matters as:

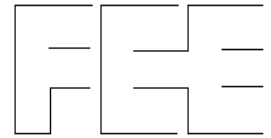
- Pensions and deferred tax (large deficits or provisions potentially inhibiting distribution of dividends);
- Share based payments (where charges for share options might have an impact on profits available for distribution); and
- Financial instruments (where fair value measurement is significant).

Annex 1 of the Action Plan proposes that a study into the feasibility of an alternative to the existing capital maintenance regime is undertaken in the medium term (2006-2008) with possible introduction into legislation along with a general modernisation of the Second Directive in the long term (2009 onwards). In so far as the alternative to the existing capital maintenance regime is concerned, this will be too late as the issues are very likely to become a pressing matter within the short term.

We most strongly urge the Commission to reconsider its timetable and ensure that the review takes place in the short term with guidance, if not legislation, being in place during 2005. The commencement of the feasibility study process, being on matters that are fundamentally new for continental Europe should start this year, so as to give the opportunity to test the results of the study before proposing the possible new system.

The study and any subsequent action, along with general modernisation of the Second Directive must, in our view, be reclassified as a high priority short term matter. This may mean that another item currently classified as short term in Annex 1 (such as the European Private Company) may have to be reclassified as a medium term priority.

FEE would be interested in participating in the debate regarding capital maintenance/solvency and in discussing any further involvement that may be appropriate.



3. Corporate Governance

3.1. Annual Corporate Governance Statement

FEE supports the proposal to require companies to make an annual corporate governance statement. FEE also supports the view of the Commission that there is no need to develop an EU corporate governance Code but rather to look for a common approach to be adopted at European level with respect to some basic key principles and criteria, combined with co-ordination of national Corporate Governance Codes (see section 3.2).

To translate the matters mentioned in the Action Plan into key principles will require considerable thought. The underlying principles should be sufficiently widely drawn to permit companies to present a balanced description of their governance arrangements, whilst avoiding proposals that result in a rigid set of factual statements or the standardised use of "boilerplate" language. Nor should these statements be treated by boards as a public relations document. Thus the principles should emphasise the need for a balanced approach.

There are, however, a few issues that we wish to raise at this stage:

3.1.1. Responsibility of Boards of Directors

It should be made clear (as with the financial statements, other parts of the annual report, and other published financial information) that responsibility for the corporate governance statement rests with the entire board. In a two-tier system, responsibilities for approving the statement should rest with both the management and supervisory board.

3.1.2 The degree of involvement of the external auditor

In its discussion paper on corporate governance, FEE encourages debate on whether capital market participants see benefits in independent assurance on appropriate elements of the corporate governance statement. FEE, at a minimum, supports as much auditor association with the corporate governance statement as is consistent with their existing responsibilities.

There are however implications for audit expectation gaps if the scope of the auditor's work and the level of assurance provided are not clearly and carefully agreed, and understood by all the parties concerned: The auditor would not be able to express an opinion on whether and to what extent the reporting company has adequate corporate governance or whether the reporting company complies with all aspects of a corporate governance code, as stated its compliance statement. An audit of the appropriateness of the compliance statement would require an audit of the propriety of management and the adequacy of management organization, instruments and transactions. Assessing the adequacy of management is the primary task of those charged with governance (NEDs, audit committee, etc.) and extending the external audit in this way would interfere with their separate responsibility for reporting on financial information. Neither would this be desirable as it would create another expectation gap with regard to the role of the external auditor.

This is a matter upon which, at a future date, we will provide the Commission with more detailed thoughts. We suggest that there is very likely to be a need for the development of guidance, for companies and for auditors, as to what is expected of them in respect of the proposed corporate governance statement.

In addition, the location of the corporate governance statement within a company's annual report is an issue that will need to be addressed as this will affect the work provided by the external auditors, the level of assurance provided and public expectations. For example, at this stage in our thinking, we do not believe that the corporate governance statement should be linked to Article 51.1 of the Fourth Directive with its requirements for external auditors. The corporate governance statement should be a separate section within the annual report.

3.1.3. Interests of minority shareholders protection

It is vital that all shareholders receive information equally and timely and we believe that the timeliness and equality of disclosure should be monitored by the (supervisory) board.

All disclosures relating to financial and non-financial performance and corporate governance should be made available to all shareholders and others, such as analysts, at the same time. We believe that the information delivery mechanism plays an important role and we agreed that electronic means, in particular the use of a company's web site will become increasingly important albeit it should not be at the exclusion of other means of communication to investors and others.

3.1.4. "Comply or Explain" approach

In creating the agreed framework for corporate governance, we support the preference given to the "comply or explain" approach. A detailed legislative requirement seems inappropriate in a matter where flexibility is necessary to give shareholders information to enable them to form their own view of the company's practices.

Companies should provide adequate information on how they have applied the relevant corporate governance principles as well as an explanation where they have not complied with a specific matter(s). Non-compliance should not automatically be regarded as either wrong or poor corporate governance, as under the specific circumstances of the company, there may be perfectly acceptable reasons that have precluded full compliance during the period covered by the annual report.

3.1.5. Institutional Investors

Disclosure on the role played by institutional investors is basically a matter of contractual relationship between these investors and their clients. FEE agrees with the Commission that institutional investors cannot be obliged to exercise their voting rights. They cannot have different rights or obligations compared to other shareholders. In any case they should be asked to disclose their undertaken positions.

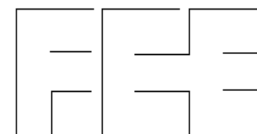
3.2. Soft Law

We agree that the development of a European Corporate Governance Code would become a useless exercise. It will be impossible to harmonise not only company law but also the cultural traditions and different national approaches in various Member States. In addition, governance codes need to be able to respond quickly to developing issues in the corporate environment. Setting the code at a European level, or even at a legislative level in each country, would introduce inflexibility into the process of responding to new trends.

It should be more effective and appropriate at the European level to:

- Set the key principles and common benchmarks of accountability for the national codes of corporate governance in Member States. This should also aid a common understanding by investors across the EU and elsewhere;
- Provide clear guidance concerning the "comply or explain" approach; and
- Through discussions and co-ordination via the Forum, help to foster a better understanding of, and results arising from common, high-level corporate governance principles.

However, care will be needed to avoid the key principles and common benchmarks becoming numerous and thus developing into a European Corporate Governance Code through an accumulation of rules. So far as possible, we suggest that the common approach should focus on the key subject headings and objectives of the designated codes for use at national level so that the



relevant national bodies can develop the detailed approaches that best meet the objectives in each Member State.

Looking to the global stage, consideration needs to be given to developments outside the EU. In an ideal world, key principles and common benchmarks should be set at global level. This will contribute to the main goal of the Communication of fostering the global efficiency and competitiveness of business. The general policy of FEE is to support global standards whereby, in all areas of standard setting, the principles based approach is preferable to the rules based approach.

4. Modernising the Board of Directors

4.1. Nomination of directors

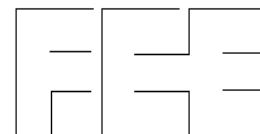
FEE is of the opinion that either a nomination committee with a majority of independent directors or the entire (supervisory) board should nominate (non-executive and executive) directors for the appointment by the body competent under national law, although recognising that specific legislation within some Member States requires a special nomination and appointment procedure for certain members of the (supervisory) board.

We strongly believe that the statement in the first paragraph of page 15 of the Communication stating that such responsibility for nominating directors should be entrusted to a group comprised mainly of executive directors is incorrect. Not only is this incompatible with much existing international practice, it is also contradictory to the Jaap Winter Group Report. We strongly recommend that the text of the Communication should be amended to read a “a group comprised mainly of independent non-executive directors”.

A significant role of the independent non-executive directors on the unitary board or the supervisory board is to ensure that within the boardroom(s) of a company an independent challenge process exists to assess the decisions of the executive or management board directors. The non-executive directors provide this oversight.

Whilst FEE fully supports the involvement of the executive/management board directors in the process of identifying potential candidates to fill future positions as either executive or non-executive directors, the final decision within the company to approve the proposed individuals must rest with a committee (or board) where the majority are directors independent of the management. To do otherwise could easily undermine the role of the non-executive directors upon which much of existing and new corporate governance proposals are founded with consequences for audit committees as well as for the oversight (and possible control) over the remuneration of executive/management board directors.

We most strongly suggest that the effect of the current proposal would significantly reduce the effectiveness of the independent challenge in the boardroom if the appointment of non-executive directors were in the gift of the executive directors. Boards could easily return to the days where they could be comprised of ‘friends of the Chairman’ or perhaps ‘friends of the Chief Executive’ with all the implications of conflicts of interest that this could bring. Good progress on corporate governance has been made in the last decade and we would not wish to see this stifled. We also suggest that the capital markets would be concerned about such a reversal.



4.2. Independence

FEE supports the objective to strengthen the role of the independent non-executive or supervisory directors. The presence of an independent element on the board, capable of challenging the decisions of management, helps to protect the interests of shareholders and, where appropriate, other stakeholders.

Independence for directors is, however, not an easy topic and in a rapidly evolving modern global economy, it is impractical to comprehensively list all the possible threats to independence. Such matters do not fit with a lengthy set of detailed rules, the spirit of which can be circumvented. We suggest that the involvement of quality individuals on the board, able to exercise objective judgement, is of greater importance than satisfying detailed rules on independence.

Where national law or codes require certain directors to be independent, a principles based approach to assess threats and safeguards to independence is a way forward. Such an approach is based on fundamental principles, which must always be observed, and any threats which could impede observance of these principles, should be identified. Where threats exist, safeguards should be put in place to eliminate or reduce them to an acceptable level. A FEE paper on this subject ("A Conceptual Approach to Independence in the Financial Reporting Chain") will shortly be available.

The (supervisory) board should, in addition to identifying the directors it determines to be independent with due regard to threats and safeguards, publish its reasons for considering a director to be independent in the corporate governance statement in its annual report in those cases where there is any doubt as to the independence of the individual concerned. Such disclosure should include the existence of relationships or circumstances which shareholders (and where relevant, other legitimate stakeholders, such as employees) might reasonably consider relevant to its determination. However, it is important to recognise that independence requirements should not prevent companies from engaging non-executive directors of appropriate calibre, and that "comply or explain" should be an available solution to any potential impairment of a non-executive director's independence.

The Communication focuses on a situation where a conflict of interests may exist between executive directors and the company, which could give lead to a narrow interpretation of the role of independent non-executive directors. This could lead to some misunderstanding on the independence requirements of non-executive directors.

4.3. Need for a consistency across the EU

In providing financial information of the highest quality to the capital markets, EU-wide consistency needs to be achieved on such elements as:

- Confirming the collective responsibility of all directors for financial reporting
- The function of audit committees in supervising the provision of high quality financial information
- The relationships and communications between the audit committee and the auditors (external and internal auditors).

Further information of FEE's comments on these matters can be found in our discussion paper entitled "The Financial Reporting and Auditing aspects of Corporate Governance".

We fully support strengthening the role of non-executive directors and supervisory direction as a short-term priority. This should include proposals on audit committees given the current discussions and developments on changing the Eighth Directive and given the importance of audit committees in the transatlantic dialogue.

4.4. The role of principles of business conduct

Principles of business conduct have an important part to play in the context of corporate governance and reputational risk management and as such each participant in the financial and business reporting chain should assume its responsibilities and should have policies and codes of business practice which include a clear obligation to act with honesty and integrity.

FEE believes that this issue has an important part to play in terms of ensuring its inclusion in any national convergence to create a common set of European or ideally international high-level corporate governance principles.

4.5 Other matters

- FEE recommends being very careful with translations of "non-executive directors" which can result in important misunderstandings about the persons who can be selected as non-executive directors (example: in French, "administrateur extérieur" is inappropriate).

- FEE supports transparency with regard to remuneration of directors. Appropriate measures should exist (for instance a remuneration committee) to avoid the possibility that the executive directors decide on their own remuneration.

5. Strengthening Shareholders' Rights

FEE agrees that enhancing shareholders' rights, if developed in a new directive, should focus on the specific situation of listed companies although some elements could also be stimulated for non-listed companies through best practice. Furthermore, improved disclosure and communication (see 3.1.3 above) will play an important role in this process and, as such, FEE would recommend encouraging the use of modern technology by companies to communicate with their shareholders (e.g. websites, e-mail).

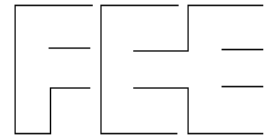
An appropriate analysis of the rights of shareholders to ask questions and to submit proposals for resolution, linked with the squeeze-out right of a majority shareholder and sell out right of minority shareholders should be taken into consideration.

Moreover, FEE also agrees on the importance of an urgent solution to be given to the specific problems relating to cross-border voting by shareholders (see also point 7). The EU should concentrate its efforts on the creation of the facilities necessary to operate and restructure across borders.

6. Groups

In principle, FEE supports the proposed expansion of related party disclosure to be required for groups beyond listed companies. In accordance with the IAS regulation, with effect from 2005 listed companies will have apply IFRS including IAS 24 which requires companies to provide information on related party transactions in their consolidated financial statements. The trade-off between cost and burden for reporting companies and the benefits for the users of financial statements need to be considered carefully if the European Commission intends to go beyond this requirement by expanding the scope of companies concerned beyond listed companies. In any case, to prevent inconsistencies with IAS 24 and its future developments the Directives should only contain a general disclosure obligation which should be filled by the respective national standard setters.

According to the Communication "The actual provisions of the Seventh Company Law Directive on consolidated accounts do not sufficiently address these concerns, in that consolidated figures do not



reflect the financial situation of the various parts of the group and the degree of dependence of the subsidiaries on the parent company."

In discussing this issue it needs to be taken into account that the financial situation of various parts of the reporting group is already provided by segment reporting under IAS 14 which should be applied by listed entities from 2005. Disclosure of intra-group transactions in consolidated accounts, however, would be inconsistent with the overall task of consolidated accounts which is to present the net assets, financial position and results of the parent enterprise and its consolidated subsidiaries as if they were a single entity. Following this approach transactions between enterprises within a group need to be eliminated in preparing the consolidated financial statements. If information about the effects of intra-group transactions on individual enterprises was considered necessary, disclosure might be considered not in consolidated but in individual financial statements (e.g. as related party disclosures), which would be an issue not for the Seventh but for the Fourth Directive.

7. European Private Company

The achievement of a really integrated single market has to offer the concrete possibility of establishing and conducting business on a genuinely European basis. This includes cross-border voting rights, which is currently made difficult by holding of shares only through a chain of intermediaries which leads to the difficulty in determining the entitlement of shareholders to exercise their voting rights. A Group of Experts appointed by the Dutch Minister of Justice conducted a study and made proposals in its first report of September 2002.

It also includes the possibility for European companies to:

- Merge across borders
- Transfer their seat from one Member State to another
- Make business as a European Company.

The problem is that the law of the Member States of incorporation is different and this makes it very difficult to make effective the right of establishment, for both listed companies and SMEs.

FEE shares the view of the Commission on the fact that the Societas Europaea (SE) adopted in October 2001 may not meet all expectations of the SMEs and is looking with interest to the possible establishment of a European Private Company (EPC).

Nevertheless FEE considers it as a priority to adopt the Tenth Directive on cross-border mergers, and the Fourteenth Directive on the transfer of seat from one Member State to another.

With these implementations to the legal framework it will be interesting to see the eventual results of the feasibility study announced by the Commission in order to clearly identify the practical benefits and the problems related to the introduction of a new legal form at EU level, serving the needs of SMEs that are active in more than one Member State. Practical problems should be clearly identified and it will be interesting to see the effectiveness of SE before developing proposals on EPC.

As noted in section 2 above, if the Commission's resources are restricted, then Commission may need to re-prioritise the current 'short term' classification for the EPC to 'medium term'.

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